

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**INTERNATIONAL  
ACCOUNTING and  
REPORTING ISSUES**

**2003 Review**

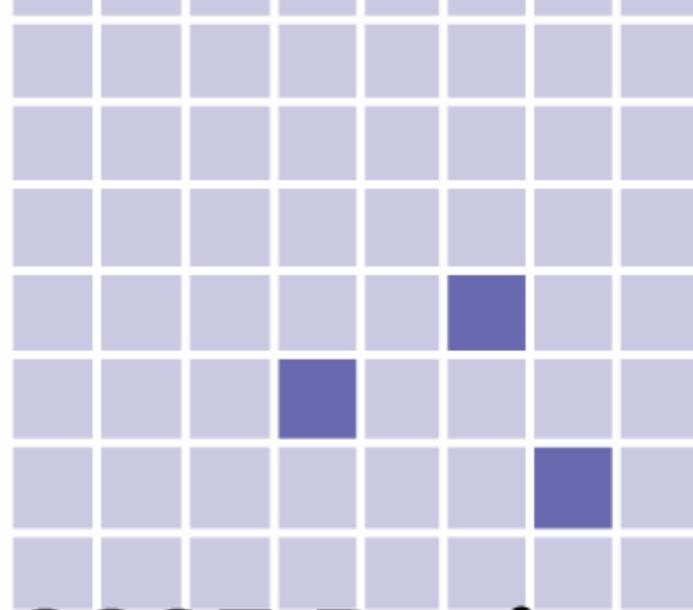


UNITED  
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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Geneva

**INTERNATIONAL  
ACCOUNTING and  
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**2003 Review**

Report by the Secretariat of the  
United Nations Conference on Trade and Development



UNITED NATIONS  
New York and Geneva, 2004

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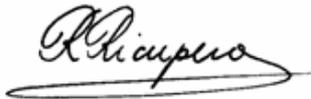
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## FOREWORD

Transparency and disclosure are essential for the efficient functioning of financial markets in all Member States. The series of corporate collapses that occurred over the past few years shows how devastating the consequences can be of a lack of transparency and disclosure for investors, employees and pensioners. UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has been contributing to the global debate and consensus-building on various aspects of transparency and disclosure, including corporate governance, reporting on the impact of corporations on society, and training of professional accountants.

The 2003 volume of *International Accounting and Reporting Issues* presents the deliberations of ISAR at its 20<sup>th</sup> anniversary session, which took place in Geneva from 29 September to 1 October 2003. It highlights important implementation issues with respect to corporate governance disclosure, including case studies on Brazil, France, Kenya, the Russian Federation and the United States, as well as current trends and issues in reporting on the impact of corporations on society. The volume also contains a revised version of the model curriculum that ISAR originally adopted in February 1999.

The volume sheds light on many issues with important global implications for economic development and financial stability, and I am confident that it will prove to be a useful resource for readers in a variety of disciplines.



Rubens Ricupero  
Secretary-General of UNCTAD  
Geneva, September 2004

## EXECUTIVE SUMMARY

This 2003 volume of the *Review of International Accounting and Reporting Issues* contains the proceedings of the twentieth anniversary session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which took place in Geneva from 29 September to 1 October 2003. The session deliberated on corporate governance disclosure requirements, reporting on the impact of corporations on society, and a revised model curriculum for professional accountants.

In accordance with its proposed provisional agenda, which was approved by the Commission on Investment, Technology and Related Financial Issues, the Group of Experts discussed five case studies on corporate governance disclosures and major issues regarding implementation of requirements in this area. The case studies were conducted on Brazil, France, Kenya, the Russian Federation and the United States. An overview of the implementation issues, as well as a summary of ISAR's deliberations at its twentieth session, are presented in the first chapter of this volume. The detailed findings of the case studies are presented in Chapters 2 through 6.

The impact that enterprises have on society has been an issue of growing concern for many stakeholders. The twentieth session of ISAR considered a report prepared by the UNCTAD secretariat on the disclosure aspect of this issue. A summary of the Group's deliberations and the paper discussed at the time are contained in Chapter 7 of this volume.

The last chapter of this volume contains a revised model curriculum for the professional education of accountants that was discussed at the twentieth session of ISAR. A summary of the deliberations of the Group of Experts also appears in the chapter

## INTRODUCTION

The twentieth anniversary session of the Intergovernmental Working Group of Experts (Group of Experts) on International Standards of Accounting and Reporting (ISAR), held in Geneva from 29 September to 1 October 2003, brought together 200 participants from 65 member States. Participants included regulators, policy makers, and national, regional and international accounting organizations. Some member States were represented at the ministerial level. Attendance set a new record.

This ISAR session marked 30 years of United Nations involvement in efforts to improve the transparency and accountability of transnational corporations (TNCs). On this occasion, a special panel reflected on the progress that had been made over the past three decades since the United Nations began promoting transparency and disclosure by transnational corporations. In 1973, the then-Secretary-General of the United Nations appointed a Group of Eminent Persons to examine the impact of multinational corporations (as they were then called) on development. The Group of Eminent Persons was struck by the unavailability of important financial and non-financial information in a useable form and the desirability of developing agreed international reporting standards. It stated that the most urgent need of developing countries was for information on TNCs so that the strategies of TNCs could be better aligned with countries' development goals.

The panel discussion of ISAR's thirtieth session stressed that the rapid pace of globalization had been slowed by a number of crises in the financial sector. Investors had deserted major capital markets because they had lost confidence in those to whom they had entrusted their hard-earned lifetime savings. While significant progress had been made over the last three decades, a series of corporate collapses over the last couple of years indicated the need for further work. One of the panelists, an academic who has been following the work of ISAR for many years, noted that the Group of Eminent Persons had charged the United Nations with setting rules or guidelines for both financial and non-financial reporting. He suggested that it was now time to return to that dual challenge and "frame a set of feasible measurements and disclosures that serve as a basis for mutually beneficial aligning of corporate activities with development objectives".

The main agenda item at the twentieth session of ISAR was transparency and disclosure in corporate governance. In response to requests at the nineteenth session of ISAR, case studies on corporate governance disclosure had been conducted on Brazil, France, Kenya, the Russian Federation and the United States. Several panel members made presentations and commented on the findings of the case studies. The event provided an opportunity for participants to learn from each other's experiences. Even though there were some differences among the countries surveyed in the types of challenges they faced in addressing corporate governance disclosure issues, these differences were outweighed by

commonalities. The presentations and the deliberations that followed identified various difficulties that member States faced in implementing corporate governance disclosure requirements. The twentieth session of ISAR achieved broad consensus on the need for practical guidance and benchmarking systems on governance disclosures.

Under other business, the twentieth session of ISAR deliberated on a number of issues. These included disclosure on the impact of corporations on society, the revised ISAR model curriculum for the professional education of accountants, follow-up work on issues discussed at previous ISAR sessions, and updates by other organizations on recent developments.

Participants discussed a report on disclosing the impact of corporations on society that had been prepared by the UNCTAD secretariat. The session noted that essential non-financial information such as economic, environmental and social impacts on various stakeholders seldom appeared in corporate annual reports. The Group of Experts recognized that, although various initiatives were underway for developing different corporate performance indicators and reports, further work was needed on examining these existing indicators so that corporate social responsibility reports would be comparable and would not impose unreasonable burdens on enterprises, particularly in developing countries.

The Group of Experts discussed various aspects of the revised model curriculum for the education of professional accountants. Participants suggested some changes to the version discussed at the session. In concluding its deliberations on this item, the Group of Experts requested the UNCTAD secretariat to continue its efforts on national and international requirements for the qualification of professional accountants in coordination with the Steering Committee on International Professional Qualifications and the Education Committee of the International Federation of Accountants. The model curriculum was part of the guideline on national requirements for the qualification of professional accountants that ISAR had adopted in February 1999.

The Group of Experts was updated on significant progress made on the due process for finalizing and issuing the draft guidance on accounting for Level 2 small and medium-size enterprises (SMEs). As had been agreed at the nineteenth session, after the incorporation of comments received then, and some that received after the conclusion of the session, the draft guidance for Level 2 SMEs had been made available for wider consultations during a period of over 90 days (ending 30 April 2003). Comments were received from all regions of the world and were, in general, favorable. Final guidance for both Levels 2 and 3 were in 2004. The Association of Accounting Technicians (AAT) conducted a field test on the applicability and usefulness of the draft guidance for Level 3 SMEs in the United Kingdom, and the overall findings were favourable. The AAT intends to conduct further field testing outside the United Kingdom in 2004. ISAR deliberated on accounting by SMEs as its main agenda item during three consecutive sessions, starting at its seventeenth session in 2000.

Progress was also reported on the work on environmental accounting, which had been the main agenda item at the fifteenth session of ISAR. During the intersession period, draft guidance for preparers and users of eco-efficiency indicators had been pilot tested by Ciba Specialty Chemicals, a Swiss company based in Basel. The pilot test indicated that the guidance was very useful and even preferable to other existing guidance on the subject. A joint project involving UNCTAD and a consortium of five Swiss universities led by the University of Geneva has made the wide dissemination of ISAR's work on environmental accounting possible through an Internet-based distance learning platform.

Several regional organizations working on transparency and disclosure issues presented developments in their respective organizations. The updates made participants aware of initiatives underway at various organizations and provided them with useful information for networking. Such updates are also useful for promoting cooperation and coordination among these organizations.

The Group of Experts proposed to work on two main agenda items at its twenty-first session: review of the comparability and relevance of existing indicators on corporate social responsibility, and review of the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value. ISAR will report to the eighth session of the Commission on Investment, Technology and Related Financial Issues on its activities in order to get the Commission's approval of the provisional agenda for the twenty-first session of ISAR.

UNCTAD would like to express its gratitude to all who contributed to the success of the twentieth session of ISAR. It particularly appreciates the leadership roles played by Prof. Nelson Carvalho, University of São Paulo, Brazil, and Dr. Nancy Kamp-Roelands, the Netherlands, as chairperson and vice-chairperson-cum-rapporteur of the session, respectively. UNCTAD would like to thank André Baladi, co-founder, International Corporate Governance Network; Heloisa Bedicks, Institute of Corporate Governance, Brazil; Igor Belkov, Institute of Directors, Russian Federation; Richard Frederick, UNCTAD Resource Person; and Ndungu Gathinji, Eastern, Central and Southern African Federation of Accountants, for their excellent work on the case studies on corporate governance. UNCTAD appreciates the valuable contributions of the members of the special panel on reflections at the twentieth session of ISAR, namely Prof. Nelson Carvalho; Prof. Frederick D. S. Choi, New York University; Robert Garnett, International Accounting Standards Board; Igor Kostikov, Federal Commission for the Securities Market, Russian Federation; and the chairperson of the panel, Prof. Peter Walton, ESSEC. Finally, UNCTAD expresses its appreciation for the contributions of secretariat staff members Yoseph Asmelash, Constantine Bartel, Rosalina Goyena, Catherine Katongola, Gwenael Quere, Tatiana Krylova, Maria Moya and Lorraine Ruffing.



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# **CHAPTER I**

## **MAJOR ISSUES ON IMPLEMENTATION OF CORPORATE GOVERNANCE DISCLOSURE REQUIREMENTS**

### **SUMMARY**

The Head of the Enterprise Development Branch of UNCTAD introduced the agenda item. She said that the Group of Experts had begun considering corporate governance issues in accordance with the request of Member States at the tenth quadrennial conference of UNCTAD (Bangkok, 2000). The series of corporate failures during the previous couple of years had only reinforced the need for further work in the area of corporate governance. At its nineteenth session, the Group of Experts had discussed a report on corporate governance disclosure requirements (TD/B/COM.2/ISAR/15) and found the report to be a valuable illustration of the convergence of opinion on the content of corporate governance disclosures. The session had also agreed on the need for further work and requested ISAR to conduct case studies on the implementation aspects of corporate governance disclosure requirements.

The Head of the Branch drew the attention of participants to the documentation prepared for the agenda item. The main paper (TD/B/COM.2/ISAR/19) contained a summary of the findings of case studies conducted on Brazil, France, Kenya, the Russian Federation and the United States of America. The detailed case studies were available as separate documents (symbols TD/B/COM.2/Add.1 through Add.5 respectively). She then introduced the chairperson of the panel of resource persons for the agenda item and invited him to present an overview of global efforts with respect to enhancing corporate governance disclosure requirements.

The chairperson of the panel discussed corporate governance “mishaps” that had occurred around the globe in recent years and various initiatives that were being undertaken to mitigate the failures. The remedies he discussed included institutional monitoring, corporate governance codes, legislative reforms, securities class actions, governance rating agencies, and accounting and auditing standards.

A panel member who had assisted the UNCTAD secretariat as a resource person in preparing the documentation for the agenda item introduced the main paper (TD/B/COM.2/ISAR/19). He discussed the rationale for selecting the countries on which the case studies were conducted and said the framework for review was the set of disclosure requirements that ISAR had discussed at its nineteenth session (TD/B/COM.2/ISAR/15). He presented some differences and many similarities among the countries studied with respect to corporate governance disclosure.

Differences included ownership structures, size of market and economies, regulatory approaches, and confidence in markets. Commonalities among the countries studied included the facts that no country was immune from corporate failures; that legislative reform was underway in all, with the active participation of the private sector; that there was consensus on what constituted good corporate governance; that the Sarbanes-Oxley Act in the United States of America had had a broad international impact; that International Financial Reporting Standards were expressed goals among most of the countries studied; and that social and environmental reporting was becoming more common. Most countries complied in broad terms with the disclosure requirements that ISAR had discussed at its nineteenth session.

Five panel members each discussed one of the country case studies. On Brazil, the discussions highlighted various initiatives underway to improve corporate governance and transparency. A new requirement in Brazil to rotate audit firms rather than just audit partners every four years drew significant attention and comments from participants. Regarding France, the dual auditorship requirement was a feature that interested several participants. The person who discussed the case study on Kenya presented various positive developments in that country geared to improving transparency and disclosure that had occurred after the case study was completed. The establishment of a cabinet-level post of permanent secretary on governance and ethics was an example. The panellist who discussed the case study on the Russian Federation said that the case study was balanced and constructive. The Institute of Directors in the Russian Federation had conducted a survey using the transparency and disclosure requirements discussed by the Group of Experts at its nineteenth session. In addition to the issues contained in the case study, the panellist who discussed the United States of America noted the ongoing nature of reforms of corporate governance and transparency and cited examples that had occurred after the completion of the case study.

A representative of the European Federation of Accountants (FEE) presented a report issued by his organization titled "Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance". The paper offered the accountancy profession's perspective as part of the ongoing debate on restoring investor confidence. The scope of the paper was limited to describing the elements of good corporate governance relevant to the process of financial reporting and auditing. The representative discussed key messages and recommendations of the paper on such issues as codes of corporate governance, audit committees, external auditors, and disclosures about corporate governance and independent directors.

During the deliberations, various implementation issues raised in the case studies were discussed. The issue of voluntary versus mandatory approaches to corporate governance transparency and disclosure compliance was extensively debated. Some delegates were of the view that mandatory regulations discouraged enterprises from implementing requirements. Others thought that enterprises would not comply with voluntary requirements, since they would not have particular incentives to do so.

There was also a view that voluntary and mandatory approaches did not need to be mutually exclusive – that it would be possible to have a combination of both approaches. While certain core requirements needed to be mandatory, certain others could be voluntary.

Some participants felt that, because voluntary compliance with requirements enabled enterprises to be more transparent, the reduced cost of raising capital that came with transparency was an incentive for them to continue to comply. A question was raised in relation to auditing corporate annual reports where compliance with corporate governance requirements was on a voluntary basis only. Some participants noted that several corporate governance requirements included “comply or explain” as one of their features. In other words, the reporting enterprise would provide the auditor with an explanation regarding those elements of a set of requirements that it did not comply with.

The issue of rotating audit firms as opposed to only audit partners was raised as part of the discussions on implementation issues. Delegates who conducted research on this issue worldwide stated that very few countries in Europe required rotation of audit firms. Some delegates were of the view that such a requirement would not be preferable to shareholders, since it would mean an increase in audit fees. Furthermore, mandatory rotation would disrupt the flow of value-added services that the audit firm was able to provide on the basis of its long experience with the entity it audited. A delegate sought clarification on whether the Sarbanes-Oxley Act required the rotation of audit firms. A member of the panel explained that the Act did not actually require rotation. However, a study on the impact of mandatory rotation of audit firms had been requested and was due to be completed within a year from the time the Act went into force.

After stating that he found the case studies instructive and interesting, a delegate commented on the need to strike a balance between self-regulation and government regulation in promoting meaningful disclosure. In some cases, self-regulation was more effective than government regulation for several reasons. Most of the expertise on issues such as accounting or derivative financial instruments rested with self-regulating organizations rather than with regulatory government organs. It would be easier to update or amend requirements issued by self-regulating organizations than those issued by government regulatory authorities, might require parliamentary approval to effect any change. The private sector tended to be more accepting of requirements issued by private-sector, self-regulating organizations than those issued by government bodies. The delegate emphasized that the need for balance in this respect was an important implementation issue.

Various delegates stressed the important role of the public sector, particularly in developing countries. The fact that most of the financial and other resources of developing countries were in the hands of the public sector made it important to promote adequate transparency and disclosure in governance of that sector. These delegates felt that, while the current deliberations of the Group of Experts focused mainly on private-sector enterprises, there was a need to develop similar recommendations on disclosure by the public sector. Some participants also thought that issues of corruption in the public sector needed to be addressed.

A delegate, referring to the case study on Kenya, asked whether it would be possible to replicate the approaches taken there in other sub-Saharan African countries, where there were no stock exchanges, the public sector was the dominant actor, and the private sector was largely informal.

The panellist who had discussed the case study on Kenya responded that, while stock exchanges might not exist in such countries, there could be cooperatives, financial institutions and major enterprises that might not be listed but played a significant role in economic development. All these entities needed to provide adequate disclosure on their operations and governance. However, it would not be practical to require such disclosures from the informal sector.

A delegate noted that, while the case studies provided good geographical balance, the inclusion of an Asian country in the study would have provided even more balance. Future case studies could focus on countries that had not been included in past case studies. A delegate from the Asian region compensated for the omission by presenting the main features of a corporate governance code that his country had implemented the previous year. He also elaborated on some of the mandatory and voluntary aspects of compliance with the code. Another delegate from the Asian region shared his region's experience with respect to a selection process for best-prepared corporate annual reports. A regional accountancy organization in his region that ranked annual corporate reports had, for selecting the best-prepared report, allocated 15 points to disclosures on corporate governance out of a total of 200 points allocated to criteria in the selection process.

A delegate whose country had completed the Reports on the Observance of Standards and Codes (ROSC) of the World Bank said that the ROSC contained a module on corporate governance and that most countries that completed the ROSC allowed the World Bank to publish such reports on its website. He said that such reports provided policy makers interested in reforming corporate governance practices in their countries with useful information in terms of approaches that other countries were taking to address corporate governance issues.

A delegate said that the terms *disclosure*, *disclosure requirement*, *disclosure on corporate governance*, *disclosure for corporate governance*, and *corporate governance disclosures* were being used interchangeably by participants in the session as well as in the documentation of the case studies. However, these terms were not necessarily interchangeable. *Disclosure on corporate governance* meant very specific disclosures about the corporate governance aspect of the enterprise. On the other hand, *disclosure for corporate governance* suggested that disclosure and transparency were only part of corporate governance. He requested the panel and participants to make a clear distinction, particularly in their use of the terms *disclosure on corporate governance* and *disclosure for corporate governance*, in further discussions and future correspondence.

A delegate who represented an accountancy body suggested that the Group of Experts could focus its future work on corporate governance on matters dealing with auditing and financial reporting, areas in which it had expertise and legitimacy, and avoid addressing issues such as the roles of directors, boards and institutional shareholders.

He also said that accountancy bodies could provide valuable training services to their members who intended to assume non-executive director responsibilities. He cited a programme at his institute as an example. Other participants mentioned various training programmes for directorships.

A delegate raised the question of whether corporate governance should be considered a preventive or curative tool. A member of the panel responded that corporate governance could be described as a contract between management and shareholders. The contract should place limits on behaviour. It was clear that in the recent past, management had exceeded those limits, and hence new laws were being enacted. Others asked if these new laws were going too far and whether corporate governance should be left up to enterprises and not regulators. A delegate expressed the view that some of the recent corporate governance laws had been enacted without taking into consideration the views of all parties that were going to be affected by them.

In concluding their deliberations on this agenda item, delegates took the position that there was a need for practical guidance in the area of transparency and disclosure requirements for corporate governance. Delegates considered such guidance useful in helping member States identify the aim and depth of their approaches to developing and upgrading their own guidelines for applying global principles. Such guidance was also considered to be useful in benchmarking enterprises in terms of their disclosures on corporate governance. The Group of Experts also considered its future work in the area of transparency and disclosure on corporate governance. Since implementation issues were raised many times, the experts decided to review the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value.

## **I. Introduction and background**

The mandate of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) is to promote corporate transparency and disclosure. In the light of this mandate, ISAR discussed best practices on corporate governance disclosure requirements at its nineteenth session. The discussions were based on the report prepared by the UNCTAD Secretariat based on the informal consultations of the Ad Hoc Group of Experts on Corporate Governance Disclosure entitled “Transparency and disclosure requirements on corporate governance” (TD/B/COM.2/ISAR/15).

The objective of that report was to provide a technical tool or checklist for regulators, enterprises and other interested parties in developing countries and in countries with economies in transition to assist them in developing their own guidelines on corporate governance disclosure. It provided a list of best practices for corporate governance disclosures required or recommended in different countries and/or used by enterprises to describe the state of corporate governance. The checklist also illustrated the increasing convergence of opinion on the content of corporate governance disclosures.

After its discussions ISAR agreed that further work was needed in the area of transparency and disclosure requirements for corporate governance, especially in the area of implementation. It was suggested that further work in this area include local case studies and implementation guidance. It was agreed that the twentieth session of ISAR would review the field case studies and consider ISAR’s contribution to the practical toolkit for corporate governance.

Consequently, five case studies were conducted. The objective of the case studies is to provide an overview of the state of corporate governance disclosure in the countries concerned and to highlight implementation issues. The studies should lead to practical insights into what has been done in selected countries to improve disclosure and what challenges those countries face regarding the implementation of international best practices. Each of the case studies could be used to draw lessons learned in the countries and share these with other member States that are interested in strengthening their financial systems by implementing improved transparency and disclosure requirements.

The objective of the present report is to summarize the findings of the country case studies and identify common issues. Such analysis is an important prerequisite for the effective incorporation of global principles into national policies. It could also improve national adaptation and implementation of corporate governance practices.

The countries in this survey are Brazil, France, Kenya, the Russian Federation and the United States of America. They were selected for the case studies because they are representative of different levels of economic development, financial market sophistication and progress in corporate governance. Additional considerations were the relevance of particular developments within the country.

It was felt that a number of other countries would also constitute a useful basis for analysis of issues related to good corporate governance disclosures. However, owing to resource constraints they could not be included in the study at this stage. Additional case studies could be conducted at a later stage if deemed necessary, *and if resources are available*, for the purpose of providing guidance to developing countries and countries with economies in transition in the implementation of best practices on corporate governance disclosure.

Each study discusses corporate governance disclosure in the context of the following issues: the institutional and legislative framework for disclosure, including stock exchanges; codes of conduct and company practices; assessment of the extent to which best practices are reflected in the disclosure requirements of selected countries and how enterprises generally comply with these requirements; and overview of implementation challenges. It is important to note that a detailed survey of enterprises' compliance with relevant regulations/requirements was beyond the scope of the case studies. This could be the subject for further study.

Each country's disclosure requirements were reviewed using the framework provided by the UNCTAD/ISAR report and cover financial and non-financial disclosure. Whilst information could not be found on all disclosure practices, sufficient information was available to provide a reliable picture.

This document summarizes key observations regarding the country case studies, grouped as those which are common to all selected countries and as those which are different. It provides a summary of governance disclosure requirements based on the UNCTAD/ISAR report as a reference point. It also highlights major implementation issues in the area of corporate governance disclosure

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## II. Key observations regarding the country case studies

### A. General observations

It is important to recognize that the countries selected for the case studies have different levels of development and that a number of differences arising in this regard have to be considered as given. While most of the differences are beyond the scope of analysis of this paper, some of them most relevant from a corporate governance viewpoint are worth mentioning. They include the ones described below.

*Size of the capital market and economy.* One of the underlying differences is the size of the markets and their relevance in the context of the national economy. Of the other selected for the case studies, Kenya has the smallest market and the United States the largest. Brazil, Kenya and the Russian Federation have limited liquidity, which makes it difficult for large investors to buy and sell without causing significant stock price movements. There are also considerable differences with respect to the level of State ownership. In Kenya, the largest enterprises are government-controlled and, in aggregate, produce a larger share of gross domestic product than the large private sector firms. Government ownership of productive capacity is low both in the United States and in France.

*There are also considerable differences in the experience with market regulation.* Some countries such as the Russian Federation have newly created markets. Others have established relatively new markets, for example Kenya. Brazil, France and the United States have the longest market traditions.

*Confidence in the market varies.* Another fundamental difference is the faith that countries have in their own capital markets. In the United States the large number of corporate restatements has shaken faith in the financial system and raised questions about its integrity. The United States is, however, a country where there has always been an enormous faith in the markets and in disclosure as an oversight tool. On the other hand, Brazil and the Russian Federation are both countries in which a profound scepticism can still be observed with respect not only to the securities markets but also to the quality and effectiveness of disclosure.

*Differences in regulatory approaches.* Some countries have more formal regulations. For example, French tradition calls for substantive legislation. Other countries such as the United States rely heavily upon disclosure-based regulations. However, the traditional focus in the United States on disclosure is shifting towards more substantive legislation, greater regulatory involvement and an emphasis on enhanced enforcement. Brazil relies fairly heavily on voluntary codes of governance promulgated by securities market regulators, listing requirements of the stock exchange and private sector initiatives. Voluntary approaches form an important component of change in Brazil. Voluntary codes promulgated by regulators also exist in the Russian Federation. Countries also set very different priorities depending upon local circumstances. For example, in Kenya and neighbouring countries, ensuring political stability is a fundamental prerequisite for economic growth. Sound private sector governance is elusive when the rule of law is not enforced. In general, it seems

that clear notions of how to deal with the large variety of issues and local circumstances are just emerging. The implementation of certain agreed upon governance principles remains a thorny question.

*Ownership structure.* One of the most fundamental differences is the ownership structure of enterprises. In most countries, control of enterprises is concentrated in the hands of a few dominant shareholders. Concentrated ownership is the norm in Brazil, Kenya and the Russian Federation. The United States and other countries of the Anglo-Saxon tradition typically have fragmented ownership. France was generally considered to be somewhere in between, until foreign investors started to buy into French enterprises. Today, foreign investors control most of half a dozen major French enterprises and may thus shift the balance of power. Different ownership structures tend to be associated with different governance problems. Countries with concentrated ownership tend to be concerned, first and foremost, with establishing and protecting the rights of certain specific minority shareholders. Countries with very fragmented ownership, on the other hand, appear more concerned about aligning shareholder and management interests.

## **B. International convergence**

*There are many factors which are common to building a sound corporate governance system and disclosure as part of it. There is a consensus on what constitutes good governance and on the goal.* Until recently there was still a debate about the meaning of governance. Consensus on what constitutes good governance is a recent phenomenon. Most national codes agree on the principles and in many cases on the level of detail. They seek to protect stakeholder rights, support the concept of independence and a balance of power in the boardroom, and recognize the importance of transparency and disclosure. Most propose board structures to promote an efficient balance of power, such as independent committees, and in particular, audit committees.

*The international reference points are clear.* The key international reference points for good practice in corporate governance are increasingly accepted. In 1999 the Financial Stability Forum (FSF) identified 12 core standards that it felt should be adopted to build and maintain a sound financial system and avoid a repetition of the Asian crisis of 1997. The FSF's Compendium of Standards identifies the Principles of Corporate Governance of the Organisation for Economic Co-operation and Development (OECD) as the international reference point in the area of governance. The key standards for disclosure are International Financial Reporting Standards (IFRS), promulgated by the International Accounting Standards Board (IASB); International Standards on Audit (ISA) of the International Federation of Accountants (IFAC); and the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO). These standards form the core of recognized international pronouncements on governance.

*Other important international codes and deliberations can serve as reference points.* These are the International Corporate Governance Network (ICGN) code on governance and its code on voting practices, the corporate governance code for the European Association of Securities Dealers (EASD) and that of the Commonwealth Association of Corporate Governance (CACG). Each is addressed to enterprises. The

OECD Principles of Corporate Governance differ in that they are the only code addressed primarily to policy makers. While national codes reflect local governance practices, most of the recent developments also draw heavily upon the knowledge acquired through pre-existing codification efforts. As a result, even national codes increasingly reflect the international consensus. The UNCTAD/ISAR Transparency and Disclosure Requirements for Corporate Governance addresses both policy makers and enterprises, and is the newest addition to this group.

*International agreement on reference points allows concerted action.* Prior to the recognition of international reference points, much of the debate surrounding governance revolved about the relative merits and demerits of insider versus outsider systems of governance.<sup>1</sup> The recognition of international reference points has allowed the debate to move on to more practical concerns. Accepted international reference points allow international institutions to better focus their assistance efforts. The World Bank's Global Corporate Governance Forum is currently engaged in partnership with the OECD in a global effort to provide policy advice on governance. Such an effort would have been considerably less focused in the absence of agreed principles of governance. The UNCTAD/ISAR list of best practices on corporate governance disclosure has also been developed on the basis of the consensus achieved on what constitutes adequate transparency and disclosure on corporate governance. It is also acknowledged that more guidance at the international level is needed in order to ensure practical implementation on points agreed.

### **C. Commonalities**

Even though there is considerable consensus on what constitutes good governance, it is often said that "one size does not fit all". Differences between countries are pointed to as barriers to the development of principles of general applicability. While differences among countries can be significant, there appears to be a fair amount of consensus on the level of principles, if not on the level of implementation.

The aspects described below could be summarized as common features of corporate governance disclosure.

### **D. Corporate governance legislation**

*Importance placed on corporate governance.* There is heightened interest in governance in general and corporate governance is certainly the flavour of the moment. Of limited interest until fairly recently, the governance movement has come into its own with activity on all fronts. The case studies show the extent to which

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<sup>1</sup> Outsider models prevail in the United States, the United Kingdom and other countries that have traditionally relied on equity markets to finance their enterprises. Ownership tends to be spread among many shareholders, with the Chief Executive Officer and management enjoying significant autonomy in relation to owners. Discipline is exercised by market mechanisms, including takeovers and the depression of share values due to sales. The insider model found in most other countries tends to be characterized by concentrated ownership that allows for close monitoring of management and close relationships between managers and shareholders. Banks may exercise discipline. The insider model ostensibly allows for closer oversight but has not proved more effective in preventing mismanagement or shareholder abuses.

countries are taking action. In each of the countries studied, corporate governance reforms are on government agendas. All of these countries have undergone recent, and in some cases profound, changes in their legislation.

Recent corporate failures have served as the impetus for efforts to improve governance practices. They have demonstrated that no country, regardless of its size and market tradition, is immune from governance problems. However, there is the risk that once the current market and economic malaise wears off, the importance of governance will be forgotten, or if it is not forgotten, that governance projects will be slowed or put on hold until the next crisis forces a re-examination.

*Enforcement problems are a commonality.* If one element stands out among the countries, it is that enforcement is an overriding concern. Most, if not all, countries have significant substantive regulation and disclosure requirements that should, broadly speaking, cover most basic governance disclosures. However, without a market regulator that can effectively monitor for violations of law and mete out punishment, the disclosure regime will not function.

*Listed enterprises are the primary concern of efforts on improved corporate governance and disclosure.* In all the countries studied listed companies are the focus of regulators and regulations. However, in all countries small and medium-size enterprises play the most important role in national economies. There are also large enterprises that are not listed but have a significant impact on society, and yet they escape disclosure requirements. This area therefore, needs further attention.

*Regulation versus voluntary approach.* Businesses tend to prefer voluntary approaches to disclosure wherever possible. One hears criticism of substantive legislation as a punishment of the majority for the failings of a few. Enterprises tend to point to the virtues of voluntary approaches and in some cases self-regulation. The theory has been that enterprises that voluntarily adopt better disclosure practices are able to improve their reputation in the market, benefit from a lower cost of capital and ultimately enjoy better cash flows and higher share values. Another advantage of voluntary approaches is that they can help avoid perfunctory disclosure or “box ticking”. On the other hand, voluntarism has its limitations. Enterprises that need to improve most are unlikely to respond. Furthermore, voluntarism without monitoring, regulation and penalties may leave the door open to widespread abuse. Voluntarism appears to have limits where a sense of business ethics is not well entrenched in society and among business leaders. Voluntarism also has limits in encouraging broad systemic change.

*Coordination among parties involved.* In all the countries reviewed it appears that a number of regulatory authorities are dealing with the governance-related issues. This may lead to inconsistency of requirements and to other complications for enterprises, which may be overwhelmed by demands for disclosure of information for different purposes. For example, some governance-related disclosure could be primarily of an accounting nature, some could be more directly related to shareholder rights, while other disclosure would reflect the interests of society. Therefore, efforts might be needed to coordinate and harmonize developments in the area of corporate governance disclosure.

## **E. The private sector**

Considerable activity is visible in the private sector as well. Most countries have already established governance codes. The case studies show an increasing number of initiatives among stock exchanges, governance associations and ratings agencies. The impact of these private sector initiatives is varied: rules set by stock exchanges can have the force of law. Governance codes, on the other hand, may be voluntary. Both can be effective. Business groupings in all of the countries under review have made governance a priority item on their agendas and are providing training and other services to improve governance in practice. It is probably safe to say that corporate governance has, in one form or another, been the topic of discussion for every publicly traded enterprise in the countries reviewed.

*Increased awareness.* The media and organizations such as ratings agencies play a key role in keeping governance practices in the spotlight. Foreign investors, who tend to make up a significant portion of trading volume on most of the exchanges that were surveyed, could be important for the transfer of knowledge about the disclosure requirements they expect to find on the basis of their experience in international markets.

## **F. Impact of the US rules**

*US rules are also a reference point and have an impact on all other countries in the studies.* Like international standards, United States governance and disclosure practices have a broad international impact. The main difference between US practices and those identified by international forums such as the Financial Stability Forum is that US standards are not agreed upon and do not undergo international consultation to the extent that international reference points do. US standards do, however, have tremendous importance as they regulate the world's largest securities market, a market that is home not only to US corporations but also to a considerable number of leading enterprises throughout the world. US rules, in particular the Sarbanes-Oxley Act of 2002 (SOA), have been examined and discussed throughout the other case study countries.

*SOA has broad international impact.* The Sarbanes-Oxley Act of 2002 is worth further mention. It has a profound impact on foreign enterprises' listing on US exchanges and level 2 and 3 American Depository Receipts (ADRs) since those enterprises do not benefit from any exceptions to the legislation. This has far-reaching consequences in a number of areas. Most foreign enterprises will have to establish independent audit committees with new responsibilities. Executives will have new obligations such as signing off on financial statements and will suffer considerable penalties for misstatements, including fines and imprisonment in the United States. Audits will have to comply with the SOA, in particular heightened requirements for auditor independence that include limitations on the services that auditors may provide to a client. This may conflict with the national legislation of foreign enterprises. There are many other requirements that are covered in some detail in the US case study.

*The international reach of SOA is causing consternation among some.* The international reach of the Sarbanes-Oxley Act has raised concerns in most countries

with enterprises that list in the United States. Some countries, in particular those of the European Union, perceive SOA as a threat to their ability to set domestic rules. Others are looking to SOA to see what practices it might be useful to adopt locally. While US practice is controversial, listing in the United States is, of course, voluntary. A number of European enterprises that had contemplated listings are now reportedly putting plans on hold to allow for further consideration of the impact of the new rules.

*The audit committee requirements of SOA are causing problems.* One of the areas in which the Sarbanes-Oxley Act is having the greatest impact is its requirement that enterprises establish audit committees that are fully staffed by independent directors. While most enterprises in the United States have audit committees, many do not, and fewer foreign enterprises do. Few audit committees globally are fully staffed by independent directors and practical questions have been raised about where to find the necessary number of qualified directors (as well as about the very definition of an independent director). Perhaps more vexing are the new powers that are given to US-style audit committees. Since the passage of legislation, they must decide on the services that auditors provide and are more directly responsible for the relationship with the auditor than ever before.

*Changes would conflict with company law.* For example, responsibilities conflict with the responsibilities assigned to “Fiscal Councils” and “Revision Commissions” in Brazil and the Russian Federation respectively as laid out in company law. In Brazil and the Russian Federation, the mission and the scope of the councils and commissions are narrower than those of an audit committee. Their focus could better be described as monitoring compliance with law and regulations. While many enterprises will seek to adapt their local structures and have them recognized as audit committees by the United States, changes to adapt Fiscal Councils and Revision Commissions to the requirements of SOA may require rewriting of company law.

## **G. Audit requirements**

*The role of the audit committee and the auditor requires further examination.* Even in the absence of developments in the United States, the role of the audit committee and the relationship between the auditor and the enterprise were being examined. Increasing demands are being made for greater professionalism and independence in all of the countries under consideration, and actions to strengthen the accountability of auditors are being considered. Practical guidance on how to establish audit committees and help them fulfil new expectations would be useful for a number of countries.

## **H. Accounting and audit standards**

*IFRS are an expressed goal.* In all of the countries surveyed, save Kenya, convergence with International Financial Reporting Standards is an expressed goal. Most countries have voiced a variety of concerns regarding their implementation. Concerns include the complicated nature of some of the IFRS, particularly financial instruments and fair value accounting, translation difficulties, disagreements over the substance of some standards, the limited size of the capital market<sup>2</sup> and limited

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<sup>2</sup> IFRS are designed primarily for companies that raise capital in the financial markets.

guidance on how to actually implement IFRS for the first time. Problems are also caused by the tax-driven nature of existing accounting, especially in *small and medium-sized enterprises* (SMEs). In the United States there is concern regarding the potential loss of control over accounting regulation as one of the most fundamental aspects of the function of its securities markets.

*Few countries have formally implemented IFRS.* Kenya stands out as being one of two countries to have formally adopted and implemented IFRS. The fact that only two countries have done so to date indicates that the process is fraught with difficulties. The absence of experience and guidance on how to manage a transition to IFRS appears to heighten the risks associated with their adoption. Notwithstanding, the direction has been set. The Russian Federation plans full convergence for 2004 for its listed companies, and European Union countries are required to comply with IFRS by 2005.

*How to implement IFRS properly is not clear.* A number of approaches to implementing IFRS exist. They include adopting IFRS word for word; modifying national standards so that they correspond in their essence to IFRS; adopting some IFRS but not others; and interpreting IFRS in such a manner that there is no conflict with national practices. Standard setters at the IASB would prefer to see adoption of the letter of IFRS and unbiased interpretation; however, the practicality of this approach is not proved.

*There is a real danger that IFRS will become watered down.* Some have expressed concern about watered down IFRS (so-called IFRS light) and the potential for different IFRS in every country. The Council of Finance Ministers of the European Union, for example, has recently indicated a possible delay in the implementation of IAS 32 and 39 that would require marking to market certain assets and liabilities.<sup>3</sup> Some argue that IAS that require fair value accounting would make it appear that many enterprises, particularly in the insurance industry, are bankrupt. Further guidance and case studies on how to implement IFRS would be very useful. ISAR has recently developed guidelines for accounting by SMEs that are consistent with IAS/IFRS.

*There does not appear to be a similar impetus to implement ISAs.* There does not appear to be a similar impetus to implement ISAs among the study group. ISAs do not yet have the same level of recognition by the International Organization of Securities Commissions (IOSCO), as that enjoyed by IFRS, and efforts are being undertaken at the International Federation of Accountants to upgrade them in the way that IFRS were upgraded prior to their acceptance by IOSCO.

## **I. Access to information**

*Access to information is a concern everywhere.* Most countries are making efforts to enhance access not only to filings but also to executives and directors through general meetings. Use of modern information technologies is also prevalent. For example, enterprises can file electronically in Brazil and the United States, and

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<sup>3</sup> Presse 201, 2520<sup>th</sup> Council meeting, Economic and Financial Affairs, Brussels, 15 July 2003, p.14.

interested users can download this information. However, there are differences in terms of the quality and quantity of filings.

*Enterprises are also making extensive use of the Internet.* The Internet has made enormous inroads in countries such as Brazil, where websites of major corporations and regulatory bodies are of a quality that compares favourably with the best internationally. The Internet, used initially as a marketing tool by companies, now provides real data to markets and investors. It also has the advantage of putting small investors on a more even footing with institutional investors who have access to screen-based services and other sources of information.

*The Internet enhances transparency but is not official disclosure.* While the Internet seems to permit significantly greater transparency, it is not fully recognized as a legal channel of disclosure. In the United States, new legislation requires that certain disclosures be filed with the markets regulator and made public on the Internet. By and large, the law and regulation relating to disclosure via the Internet are still being developed. The Internet also raises issues regarding its global reach and the international effects of its regulation. Despite open questions about its status as a disclosure channel, its potential as a rapid and cost effective means of transmitting information is proven.

*Countries are concerned about being understood.* One of the manifestations of this is the increasing use of the English language in disclosure. In France, English appears to have been adopted alongside French as an official financial language. French enterprises have increased their use of English in both the NextPrime and the NextEconomy segments of the Euronext exchanges, whose official language is English. Brazil caters to the needs of foreign investors by requiring the use of a common business language for its highest-level listings. While English-language disclosure is not, ostensibly, a concern in the United States, legislators and regulators increasingly call for disclosure in “plain English”. Much US disclosure has been criticized for its opacity. Disclosures that were crafted by financial markets professionals have been found to be simultaneously factually correct and entirely incomprehensible—sometimes even to the experts who wrote them.

## **J. Increased social and environmental disclosure**

*Social and environmental disclosure is making impressive inroads.* Many of the enterprises in the study provided extensive information on their social and environmental practices. Law does not generally require this information, however; enterprises provide it voluntarily.

*This type of disclosure still suffers from limitations.* The limitations on both social and environmental disclosure are well understood. By their very nature, social and environmental disclosures may suffer from difficulties in measurement. Some of the factors that are disclosed are qualitative and, unlike in financial accounting, cannot be quantified by a simple bottom line. The ISAR guideline for environmental costs and liabilities, and the ISAR manual for eco-efficiency indicators, have been used by the European Commission, stock exchanges in developing countries and enterprises as a useful starting point for environmental disclosure. However, social disclosure is still an emerging field, and there is considerable room for improvement in terms of comparability of reporting, consistency and verifiability of information. In the absence of standards to make information more credible, some companies use

disclosure as a marketing tool without necessarily changing the substance of their actions.

*Rules regarding the conduct of general meetings are being improved.* Annual general meetings of shareholders cannot be considered anywhere as sufficient means of communicating with shareholders. General meetings evolved out of historical reporting practices that are today largely outdated. Today, official filings, the Internet, analysts' meetings and direct meetings with large shareholders are more effective means of communication. General meetings nevertheless continue to play an important role by providing a forum in which executives can be held publicly to account. The procedures for filing notice, amendments, resolutions and voting procedures are being improved with a view to enhancing timeliness, relevance and fair and open access.

#### **K. Other commonalities**

*Other issues regarding disclosure.* Some other observations common to the countries reviewed relate to the confidentiality of information to be disclosed; timeliness of disclosure, especially in relation to price-sensitive information; and the role of intermediaries such as lawyers, analysts, consultants and other advisers in the disclosure process.

#### **L. Differences**

Despite the commonalities outlined above there are significant differences in governance-related disclosure among the countries that were reviewed. Some of the implied differences related to economic, political and cultural areas were discussed above. However, in relation to corporate governance disclosure these differences in most cases appear to be more in terms of the scale of changes and resources needed rather than in terms of the substance of these changes. Although improved corporate governance requires significant resources in all countries, costs are relatively higher for emerging countries as their institutional infrastructure and regulatory framework are at present less equipped for the efforts needed. For example, the gap between their current accounting/reporting systems and international requirements is much wider than in more developed markets, and they will therefore need more resources and more time to implement IFRS and financial reporting requirements.

Countries also differ in terms of their access to and participation in the process of developing new benchmarks and requirements on improved corporate governance and disclosure. At present, developing countries and countries with economies in transition are less involved in the international processes of identifying best practices on corporate disclosure. Therefore, many of these countries which are most in need of being guided in the process of what is needed for improved transparency are not part of such discussions, although their wider involvement may be beneficial for facilitating consensus and buy-in of the worldwide agreed best practices.

### **III. DISCLOSURE PRACTICES COMPARED TO THE ISAR TRANSPARENCY AND DISCLOSURE REQUIREMENTS**

Disclosure practices were surveyed in the process of compiling the case studies and were compared with the ISAR Transparency and Disclosure Requirements, which are divided broadly into areas of financial disclosure and non-financial disclosure.

*Financial disclosure.* In the area of financial disclosure all countries have requirements for the disclosure of the enterprise's financial and operating results, related-party transactions and critical accounting policies. However, even with detailed disclosure requirements, not all enterprises actually disclose the financial information necessary for *both* shareholders and other stakeholders to properly understand the nature of the business. In some cases, local accounting standards are simply not suited to the task. In other countries, enterprises may comply with the letter of the law while subverting its spirit. In others still, disclosures may be so convoluted that they are incomprehensible even to the most sophisticated reader. Accounting policies are generally disclosed in all of the countries, although the impact of alternative accounting approaches is generally not discussed.

*Transparency in ownership and control.* In most of the countries reviewed, transparency in ownership and control structures could be considerably improved. In many cases, beneficial ownership remains difficult to ascertain, and pyramid structures and interlocking board directorships may make conflicts of interest difficult to detect.

*Non-financial disclosure.* Disclosure requirements in the countries studied compare favourably with these requirements. Perhaps one exception is that enterprises are not generally required to disclose the rules and procedures governing the acquisition of corporate control as specified in the requirements. These rules and procedures are more likely to be found in legislation, regulation and stock exchange rules. Enterprises in all countries are generally required to disclose extraordinary transactions such as mergers and sales of substantial portions of corporate assets, and are required under certain circumstances to seek shareholder approval.

*Board processes.* The ISAR recommendations cover a large number of aspects of board processes, including the following: the structure, role and functions of the board, and board committees; duties and qualifications; evaluation mechanisms; directors' remuneration; succession planning; and conflicts of interest. Disclosure in the countries studied was good on a general level, but becomes progressively weaker as the requirements become more detailed.

All countries have general requirements for disclosure of the composition of the board, and the balance between executive and non-executive directors. Requirements for the disclosure of the existence of key committees are usually present. Disclosure of the functions of individual directors, on the other hand, is not usually made. The duties of individual directors, and the number of directorships held, are also not generally disclosed. Qualifications and biographical information are

required, but the information provided in practice may be limited, thus making it difficult to assess the competence of directors in many countries. Disclosures can range from relatively detailed information to simple lists of the names of board or committee members.

The ISAR report suggests disclosure of *potential compromises affecting the independence* of directors and disclosure of why they are not significant. Requirements for evaluation of the level of independence and explanation of cases in which there is doubt are not widely apparent and disclosure seems limited. Detailed disclosure on development and training, and continuing education could not be found, nor on professional advice that has been sought. Performance evaluation of the board is rarely disclosed, much less how performance evaluations are used to improve governance.

*Disclosure on salary, share options and other associated benefits, financial or otherwise.* Executive and director remuneration is a sensitive issue in most countries. Filings in the United States provide the most detailed disclosure on the compensation of executives and board members, including the number of options, and information on other benefits. Disclosure in France appears to be good, though generally in aggregated form. Remuneration disclosure is low in the Russian Federation. A small number of enterprises, primarily in the United States, are disclosing the costs of their options voluntarily.

The length of directors' contracts and potential compensation for severance payments in the event of a takeover could not be determined in any of the countries. In the United States details of "golden parachutes" that would be triggered in the event of a takeover must be disclosed in proxy statements. Succession planning is another topic on which there appears to be limited disclosure. Specific succession plans for key executives and other board members do not appear to be generally disclosed. Conflicts of interest do not appear to be generally disclosed, nor do formal procedures to address conflicts of interest.

Material information regarding *employees and other stakeholders* is generally disclosed. The use of the materiality concept to distinguish mandatory from voluntary disclosure is important. Traditional definitions of materiality come from the financial markets and generally refer to information that may impact on the decision of an investor to buy, sell or hold shares. Definitions that correspond to this general notion of materiality from the point of view of the investor are common in accounting standards.

However, what is material to an investor—a significant change in earnings projections—may be of less interest to an employee or the public, who might be interested in planned layoffs. This latter type of disclosure may or may not be material from an accounting perspective, and while some enterprises in all of the countries surveyed disclose information relevant to other stakeholders, this type of disclosure suffers from an absence of recognized standards and practices. Enterprises may be obliged to disclose certain key employee rights and mechanisms for protecting the rights of employees in the workplace. These types of obligations are generally found in labour law. The extent to which these types of disclosure are required for other

stakeholders beyond labour and shareholders could not be determined in the case studies.

The ISAR requirements outline a need for information on the enterprises' *environmental and social stewardship*. Examples of social and environmental disclosure could be found in all countries, although its prevalence and the depth of the disclosure varies. Enterprises in Brazil, France and the United States showed some sophisticated practices. Disclosures tend to be made by enterprises that have a significant environmental or social impact, such as energy providers or providers of public transportation services. Legal requirements tend to be fairly limited and most enterprises develop their own approach to reporting. The exception is France, where enterprises are required to produce a "social balance sheet".

The ISAR requirements discuss assurances regarding *risk management* objectives, systems and activities, provisions for mitigating the possible negative effects of risk-bearing activities, and internal control systems and their effectiveness. Material foreseeable risk factors are usually discussed in filings for initial public offerings. In addition, certain risk factors must be disclosed in the financial statements according to most accounting standards if there is a reasonable presumption that they could occur. Management is generally responsible for reporting that appropriate internal control systems are in place. The extent to which the board is responsible for disclosing the mitigating of negative effects of risk-bearing activities could not be ascertained.

The ISAR requirements suggest that the board disclose that it has *confidence that the auditors are independent*, as well as in the process for interaction with and appointment of internal and external auditors. In many countries efforts are underway to increase auditor independence and to make the auditor increasingly responsible to the board as a representative of shareholders, rather than management. Implementation of this broad objective manifests itself through mandatory independent audit committees in the United States and limitations on the services that auditors can provide the enterprise in Brazil. In both countries, the board must fulfil certain responsibilities to help ensure auditor independence, for example the approval of non-audit services rendered by the auditor. An assessment of current rules would not appear to specifically require that the board disclose that it has confidence in the independence of the auditor and that the auditor's independence is uncompromised, or in the process for interacting with the internal and external auditors.

The ISAR requirements suggest that *notification of the agenda* be made in a timely fashion in an internationally used business language. All countries have established rules governing the timing and content of notification. None have an across-the-board requirement for notification in an international business language, although Brazil has a foreign-language disclosure requirement for enterprises that are listed on foreign markets.

## IV. CONCLUSIONS

The comparison of the disclosure requirements of the countries covered in this survey should be cause for optimism. Countries have legislation and regulation that correspond well not only with ISAR's Transparency and Disclosure Requirements for Corporate Governance but also with the requirements at the detailed level. However, enterprise practice across the study group varies widely.

Enforcement and legal recourse are of paramount importance. Beyond enforcement, other key elements that need to be in place are active owners that are able to exercise their rights effectively, particularly voting rights.

The case studies illustrate clearly that disclosure has its limitations. No amount of disclosure or substantive regulation will be able to prevent individuals who are intent on defrauding enterprises from doing so. This does not, however, diminish the importance of disclosure as an oversight tool. A well-conceived disclosure regime remains one of the most effective oversight tools available.

The costs of disclosure are real and cannot be ignored. Some of the direct costs related to improved governance disclosure are for the hiring of staff to develop procedure and documents. There are also indirect costs. Governance requires executive and managerial time, and education and training are required in order to instill new attitudes, techniques and approaches. However, the benefits are likely to outweigh the costs when one considers, for example, the enormous losses in asset values, costs of layoffs and the loss of pensions that were suffered as a result of the Enron bankruptcy in the United States and the damage to the credibility of financial markets. Therefore, one of the prerequisites of improved disclosure on corporate governance is that sufficient resources be available for this in both the public and private sectors.

*Implementation, more than policy guidelines, is country-specific and idiosyncratic.* There is a broad consensus on the principles that determine good governance. However, there is considerably less agreement on how to implement those principles. Each country has specific conditions, related to the size of markets, the effectiveness of the judicial system, the sophistication of investors, the quality of public sector governance, resources and the development of the business media, among others. The list could be extended indefinitely. Implementation is a highly specific exercise. More than with general principles, one size does not fit all.

*There might, nevertheless, be some areas that might lend themselves to a "toolkit" approach.* This being said, some areas have emerged from the cases that would appear to benefit from further practical guidance. These include guidance on the role of the audit committee in governance; how to establish and run effective audit committees, including their relationship with the auditors; the introduction of IFRS; and addressing the problem of improved accounting by SMEs.

Improvements in governance are much more likely to have a positive impact on emerging and developing markets than in established markets. While challenges in developing countries are greater than in countries with established markets, the benefits of governance can also be expected to be proportionally larger. The

premiums that investors demand from enterprises in countries where governance falls below their expectations are considerable. By closing obvious gaps, developing countries have the opportunity to reap considerable benefits.

The case studies show that ISAR could further contribute to improved transparency and disclosure in corporate governance. It may consider developing its work in this area further, with a view to drawing up implementation guidelines on transparency and disclosure on corporate governance. Such an output could become voluntary technical guidelines and could be of particular benefit to member States that are in the process of reviewing their requirements in this area, as well as to those that are beginning to consider putting in place transparency and disclosure requirements. The twentieth session may call on an ad hoc group to conduct consultations during the inter-session period and present proposals on implementation guidelines to the twenty-first session of ISAR.

# **CHAPTER II**

## **CASE STUDY ON CORPORATE GOVERNANCE DISCLOSURE IN BRAZIL**

### **I. INTRODUCTION**

Government and regulators in Brazil recognize that corporate governance is one of the main factors holding back the development of Brazil's capital markets and are keenly aware of the link between the size and health of capital markets, the cost of capital and overall macroeconomic growth.<sup>1</sup> As a consequence, a number of initiatives have been launched, some of them quite innovative, in order to enhance the governance of companies. Brazil continues to work on legislative and regulatory reforms, as well as on the use of voluntary market mechanisms to encourage companies to improve their governance; this makes the country an interesting case study.

The Brazilian capital market represents some 60 per cent of the total trading volume in Latin America. Some 550 companies are listed on the Bolsa de Valores de São Paulo, or the São Paulo Stock Exchange (BOVESPA), although only about 100 to 150 companies are suitable for investment.<sup>2</sup> While figures have fluctuated considerably over the years,<sup>3</sup> the total capitalization of the Brazilian market is approximately 400 billion Reals or US\$140 billion.<sup>4</sup> In 2002, foreign investors made up 22.4 per cent of the shares traded on the exchange (figures have exceeded 35 per cent in the past) – 29.4 per cent were institutional investors, 22.5 per cent individuals and 21.3 per cent financial institutions.

The Brazilian market has some unique features that define the governance of its companies. In some countries, most typically those with an Anglo-American market tradition, ownership of publicly traded companies is dispersed and the governance dynamic tends to revolve about the separation of ownership and control.<sup>5</sup> In these countries, discussions on how to improve governance inevitably focus on how to better align the interests of owners and professional managers. Disclosure is considered one of the most important tools for exercising oversight over management.

In Brazil, as in the majority of other countries, ownership is concentrated. Most Brazilian companies are controlled by dominant groups (often families who fulfil the role of owners as well as managers) and the alignment of owner and managerial interests is a given. Ownership structures in Brazil therefore have more in common with companies in certain continental European countries than with countries of the Anglo-American tradition. While disclosure remains a valuable tool for exercising oversight, discussions on how to improve governance in Brazil tend to focus on how to avoid abuse by controlling shareholders and the expropriation of minority shareholders.

Concentrated ownership in Brazilian companies is the result of history and legal tradition. Ownership concentration was encouraged by the Corporate Law,

which until recently allowed companies to issue non-voting shares, referred to as “preferred shares,” of up to two thirds of a company’s capital. This rule effectively allowed owners to broaden the shareholder base while maintaining control of the company. As a result of recent changes to the corporate law, the percentage of non-voting preferred shares that a company may issue was raised to 50 per cent.<sup>6</sup> The vast majority of shares on the open market are preferred non-voting shares that tend to trade at a discount compared with voting shares with control rights.

Arguably more important than the two share classes in maintaining control over Brazilian enterprises is the use of pyramid structures. Pyramid structures are used in more than half of Brazilian enterprises to dramatically leverage control. A number of large Brazilian firms are fully controlled by owners who hold as little as 8 per cent to 10 per cent of their capital.<sup>7</sup> Pyramid structures generally obscure the true control structure of an enterprise and often distort the relationship between control and ownership.<sup>8</sup>

Changes to the legal framework in Brazil are complex and difficult to achieve. A number of attempts were made to increase the free float of Brazilian enterprises and enhance the attractiveness of the Brazilian markets. Most notably, an attempt was made in the early 1990s by the Comissão de Valores Mobiliários (CVM), or the Brazilian Securities Commission, to amend the Corporate Law by reducing the percentage of preferred non-voting shares that companies are allowed to issue from two thirds to 50 per cent of the capital stock. While this amendment was finally introduced into law, the original bill was suppressed owing to strong corporate opposition and its passage did not occur until almost ten years later.

While desirable from the point of view of proponents of a more active securities markets, controlling shareholders are, understandably, opposed to changes that would reduce their capacity to run companies as they see fit. The failure of the CVM bill illustrates the enormous effort required to make substantive changes to Brazilian law. It also explains to a considerable extent the alternative approach pursued by the CVM and BOVESPA, which relies on the promise of a reduced cost of capital for companies that voluntarily comply with better governance practices. Whether the incentives provided to companies by a reduced cost of capital will outweigh the private benefits that can be extracted by controlling shareholders will be one of the key findings of the Brazilian experiment.

Concentrated ownership in Brazil is also due to the Government’s privatization strategy. Brazilian privatization did not set aside shares for distribution to the public as occurred in France, Spain and the United Kingdom, where discounted shares were reserved for public purchase. In Brazil, pension funds, banks and other institutional investors bid for controlling blocks of State-owned companies. The result has been the creation of investor groups that are typically governed by shareholder agreements. Some investment holding companies were created in Brazil for the sole purpose of taking advantage of the tax write-offs of goodwill resulting from acquisitions. More pernicious cases occurred in which holding companies were used to dilute minority shareholder interests. The CVM has had to intervene in these cases, with mixed results.

Another important feature of Brazilian governance is the two-tiered board. As in most countries, the general assembly of shareholders is the highest decision-making body of the company. It is responsible for nominating and approving the Conselho de Administração or Administrative Council, which corresponds to the board of directors under a unitary board system. The Administrative Council determines the basic guidelines and policies of the company, establishes its strategy and reviews business plans among other things. Up to two thirds of the Administrative Council may perform executive functions. The Administrative Council, in turn, appoints the Diretoria or the executive board and the independent auditor. The Diretoria is responsible for day-to-day management and for the implementation of the broad directions established by the Administrative Council. Its members are vested with the exclusive power to act on behalf of the company.<sup>9</sup>

This structure is complemented by the Conselhos Fiscais or Fiscal Councils.<sup>10</sup> Brazilian Fiscal Councils are intended to provide an oversight function. They have no decision-making powers, but may review managerial decisions from a legal perspective and verify managerial compliance with company by-laws.<sup>11</sup> One seat on the Conselho Fiscal is typically granted to preferred shareholders and another to minority shareholders holding more than 10 per cent of ordinary shares. The Conselhos are composed of at least three and not more than five members to be elected at the general assembly. They serve a one-year term after which they can be re-elected. Members may or may not be shareholders and there is no explicit requirement for independence. Only a person who is a university graduate and has held a position of corporate officer or has been a member of a Conselho Fiscal for at least three years may be elected. A requirement for legal residence in Brazil was recently dropped.<sup>12</sup>

The principal factors driving better disclosure are a combination of domestic and external forces. As in other countries, broad support for governance reform, whether through legislation or otherwise, often comes as a result of broadly publicized company failures. In Brazil, cases of accounting fraud have sparked greater interest in governance and transparency. In response, a number of initiatives were introduced in the Congress, including legislation to enhance disclosure and force companies to give more rights to minority shareholders. External influences are primarily the listing requirements for Brazilian companies on foreign exchanges and the demands of foreign investment funds.

This case study focuses on developments that have occurred within the past two years. The appendix includes a comparison of Brazilian governance disclosure requirements to the ISAR Transparency and Disclosure Requirements for Corporate Governance. Further details are furnished where available and references are included to lead the reader back to original sources.

## **A. The public sector**

### **Legislation**

The principal laws that establish and regulate the functioning of the Brazilian securities market are Law 6,385 as amended (the Securities Market Law) and Law 6,404 (the Corporate Law). The Securities Market Law establishes the Comissão de

Valores Mobiliários (CVM), or Securities Commission, which together with the Central Bank implements the policies of the Conselho Monetário Nacional (CMN) or National Monetary Council. The CVM is the primary institution responsible for the regulation of accounting and reporting of publicly traded companies.

The Corporate Law requires filing of audited annual financial statements that include a balance sheet, a profit and loss statement, a statement of changes in equity, notes to the financial statements, management's discussion and analysis (MD&A) and the report of the independent auditor. Unaudited quarterly statements are required within 45 days of the end of the first three quarters of the fiscal year.<sup>13</sup> Annual and quarterly statements must include governance-related information, including information on shareholders, directors, management and affiliated companies.

Companies that have foreign listings and produce financial statements according to the generally accepted accounting principles of another country are required to disclose their foreign statements in Brazil. The Corporate law also determines that the appointment and removal of auditors is the responsibility of the Administrative Council or board of directors. As is the case with European Union requirements, private companies organized as Sociedade Anônima or joint stock companies must file statements with the Board of Trade and publish their results in newspapers.

In 2001, changes to the Corporate Law were approved by the Senate. The changes altered governance practices in Brazil, making them more transparent, more democratic and more favourable to minority shareholders. "Tag-along" rights now require that voting shares be bought out at 80 per cent of the price offered for a controlling stake, and only 50 per cent of shares issued can now be "preferred" (non-voting) shares. With respect to disclosure, members of the Conselho Fiscal must now provide their opinions to the AGM and must disclose dissident votes. Most observers feel that the changes are necessary steps in the right direction but insufficient to bring Brazilian governance up to the required level. As is often the problem with highly detailed legislation and regulation, it may be easy for companies to adhere to the letter of the law while not complying with the spirit.<sup>14</sup>

### **Securities Commission (CVM) Rules and Regulations**

In June 2002, the CVM published its Recommendations on Corporate Governance. These recommendations are described by the CVM as "good" corporate governance practices that exceed the requirements imposed by law and its own regulations. On the other hand, the CVM also recognizes that its recommendations are not "best practice" and encourages companies to voluntarily seek a higher standard. The CVM pursues a "comply or explain" policy with respect to its recommendations. The recommendations focus to a large extent upon issues of transparency in the ownership and control structure of the enterprise and on other needed disclosures. The disclosure-related elements of the code are summarized below:<sup>15</sup>

- AGMs should be organized in such a fashion as not to hinder shareholder participation; recommendations provide for an appropriately detailed agenda and timely notice.

- The company must disclose all shareholder agreements to which the company is party.
- Shareholder lists must be disclosed. Shareholders holding at least 0.5 per cent of outstanding shares also have the right to full contact information about other shareholders.
- At least two members of the board must have experience in finance and primary expertise in accounting.
- The board should establish specialized committees, in particular an audit committee to review relations with auditors, operating results and related party transactions. Members of the audit committee should have experience in finance and are responsible for supervising the relationship with the auditor. The audit committee must ensure that other services provided by the auditor not constitute a conflict of interest. It must, in addition, establish a maximum level of fees for non-audit services.
- Transactions between related parties should be clearly disclosed in the financial statements as “normal” or arm’s-length transactions.
- Companies must provide an MD&A discussing the factors that influenced financial performance and covering the main risks.
- The recommendations seek to professionalize the function of the *Conselho Fiscal* or fiscal council. The fiscal council is to have access to all information relevant to matters it is considering as long as the provision of information does not violate legal secrecy requirements.
- Companies should provide audited financial statements prepared according to International Financial Reporting Standards (IFRS)<sup>16</sup> or United States Generally Accepted Accounting Principles (GAAP) in addition to Brazilian accounting standards.
- Auditors’ recommendations must be reviewed by the full board and by the fiscal council.

Mandatory disclosure is determined by: CVM Instruction 202, which covers initial registration requirements and periodic reporting; Instruction 31, which covers disclosure of material information; and Instructions 69 and 299 (updated by instructions 358 and 361 respectively), which cover disclosures regarding the acquisition of blocks of shares. These Instructions require the filing of audited annual financial statements as defined under the Corporate Law, and unaudited quarterly statements. More stringent penalties for disclosure violations have been introduced recently to encourage better compliance with rules that are not infrequently flouted. Statements must be filed both with the CVM and with the exchange on which the company is listed, where they are generally accessible via websites.

With respect to the attestation of statements, the CVM requires the certification of annual financial statements by an independent auditor duly registered with the CVM. In order to register, auditors must: (a) submit to examination in order to ascertain their technical qualifications; (b) demonstrate that they have internal controls that ensure compliance with audit norms; (c) undergo regular peer review; and (d) institute continuing professional education programmes.

In May 1999 the CVM introduced new registration requirements, found in CVM Instruction 358, that are based in part upon IOSCO<sup>17</sup> resolutions on International Standards of Audit (ISA). The new rules: (a) prohibit independent

auditors from acquiring securities issued by their clients or any associated entities; (b) mandate forced rotation of audit firms; and (c) prohibit accounting firms from auditing entities from which they are not independent.

The list includes services that auditors may not provide to clients if they wish to maintain their independence. They include (a) corporate restructurings; (b) valuation of enterprises; (c) asset valuation; (d) assistance in valuing provisions; (e) tax planning; (f) internal control systems; and (g) any other services that may threaten auditor independence. The prohibition on certain services contained in Instruction 358 anticipated by a number of years similar legislation passed in the United States in the wake of the collapse of Enron. Instruction 381 mandates the disclosure of permitted service fees.

### **Accounting standards**

There are two recognized sets of accounting principles used in Brazil: (a) Corporate Law principles; and (b) the so-called *Correção Monetária Integral*, which is an accounting method established by the *Conselho Federal de Contabilidade* or Federal Accounting Council (CFC) that restates the financials to adjust for inflation. The principles established by Corporate Law principles are legislated and are applied by all Brazilian companies for tax and financial reporting. CFC statements are not required but are sometimes provided in addition to statements required by law.

In addition, the *Instituto dos Auditores Independentes do Brasil* or the Brazilian Institute of Accountants (IBRACON),<sup>18</sup> a private sector professional body, issues standards that supplement both sets of principles. These standards are endorsed by the CVM and are used by publicly traded companies. Further instructions may be issued by the CVM. Where specific rules regarding a particular accounting treatment cannot be found in domestic sources, Brazilian companies may look to IFRS or US GAAP for guidance.

Brazilian accounting standards differ significantly from IFRS. The most significant differences are outlined in a survey conducted by the Big 5 accounting firms, *GAAP 2001: A Survey of National Accounting Rules Benchmarked Against International Accounting Standards*. The survey compares domestic standards with IFRS and groups differences into four major categories: (a) rules comparable to IFRS are absent; (b) specific rules requiring disclosure are absent; (c) inconsistencies between rules could lead to differences from IFRS; and (d) other issues could lead to differences from IFRS. Some of the differences in the first category (the area that could result in the greatest differences in financial statements) relate to rules on recognition and measurement, the consolidation of special purpose entities, employee benefits obligations, intangible assets, impairment of assets and leases among others.<sup>19</sup> Brazil was also one of the 59 countries surveyed in *GAAP Convergence 2002*.<sup>20</sup>

It is broadly recognized that convergence with IFRS could enhance the quality of financial reporting considerably. With this objective in mind, the CVM commissioned a group that will recommend how to harmonize Brazilian accounting practices with IFRS. The proposals that are being discussed would require changes in the Corporate Law that would include the introduction of a cash flow statement in place of a statement of changes in financial position, a new format for the income statement, increased disclosure of segment information, extraordinary items, and

discontinuing operations among others. Statements would need to be consolidated where applicable and audited.

While these reforms are necessary, some observers question whether accounting principles should be embodied in law at all. It is not uncommon for countries to include detailed instructions for both accounting and audit in law. However, legislation tends to be an unwieldy instrument, ill adapted to the constant revision and improvement that accounting and audit standards require. It is often suggested that the law set out only the broadest fundamental requirements and derogate the authority for technical rule making to specialized standard setters.<sup>21</sup> Other observers, citing the danger of watered down standards, suggest that IFRS be applied directly without modification or adaptation by a local standard setter.

## **B. The private sector**

### **The São Paulo Stock Exchange (BOVESPA)**

The São Paulo Stock Exchange (BOVESPA) was founded on 23 August 1890. Until recently Brazil had nine stock exchanges. Until the mid-1960s, BOVESPA and other Brazilian exchanges were official entities linked to the finance departments of the Government. These exchanges were all merged in 2000 into BOVESPA. BOVESPA is now a self-regulatory organization under the supervision of the CVM. It has captured the attention of the international corporate governance community through its innovative use of market forces to encourage voluntary improvements in disclosure and corporate governance.

The main features of its new approach are the creation of three new listing segments: the *Novo Mercado* or New Market and two “Differentiated Corporate Governance Levels” (referred to as Level 1 and Level 2 listing segments). The *Novo Mercado* was established as a completely new market for initial public offerings with stricter listing requirements than companies already traded on the regular exchange. The Differentiated Corporate Governance Levels are intended to apply to companies already listed on the exchange. Listed companies may now receive a higher level rating based upon compliance with higher standards of corporate governance.

The additional commitments made by Level 1 BOVESPA companies revolve primarily around enhanced transparency and disclosure. Level 2 companies undertake to go further by using internationally accepted standards for accounting and by adopting rules of governance designed to better balance the power of controlling and minority shareholders. The *Novo Mercado* listing rules correspond in their essence to a Level 2 listing on BOVESPA. In addition, *Novo Mercado* companies commit to only issue voting shares that have one vote.

Listing on these special segments has some important implications. The board of directors and officers must sign a contract agreeing to a set of new commitments. All three segments must maintain at least a 25 per cent free float and either guarantee access to shares for all interested investors or allocate 10 per cent of their total offering to individual or non-institutional investors. The “dispersion procedure” must be described in the company prospectus. In the event that a company no longer wishes to be listed under Level 2 or *Novo Mercado* rules, it must seek shareholder approval

for the change and make a public tender for the outstanding shares of the company at the fair market value<sup>22</sup> of the company. Level 2 companies must also abide by the decisions of a Market Arbitration Panel, established by BOVEPA to resolve shareholder disputes. Penalties may be imposed if rules are violated.

The efforts of BOVESPA since the launch of the new levels have focused on encouraging companies to voluntarily migrate to higher levels. The benefits of migration and greater transparency are supposed to be a lower cost of capital and improved reputation for companies. Benefits for the stock market are improved liquidity and international recognition as a significant exchange.

In addition, shortly after creating the new listing levels, BOVESPA introduced a new market index composed of companies listed on the *Novo Mercado* and Level 1 and 2 BOVESPA companies. The IGC or “Corporate Governance Index” was the only one of Brazil’s five major indices to end the year in positive territory in 2002. A summary of the new reporting requirements for the two corporate governance levels follows:<sup>23</sup>

**Level 1 reporting requirements:**

- Quarterly and annual consolidated financial statements, including consolidated and unconsolidated cash flow statements.
- Disclosure of the beneficial owner of any direct or indirect interest in the company in excess of 5 per cent of voting capital.
- Disclosure of the number and type of shares held by controlling shareholders, members of the board, members of the fiscal council and executive officers. This information may be disclosed in aggregated form.
- Report on purchases or sales and changes in the types of securities held by the above group within the preceding 12-month period on a monthly and individual basis.
- Report on the level of free float.
- A special “review report” issued by the independent auditor of quarterly financial statements.
- An opportunity to meet with analysts and other interested parties in order to discuss the company’s financial condition and prospects at least once a year.
- The company must publish an annual agenda that lists all important dates such as meetings, release of quarterly numbers and other relevant events.
- Related party transactions must be disclosed in excess of certain limits, including sufficient data to evaluate whether transactions have taken place under “normal” market conditions.
- Shareholder agreements must be disclosed.
- Information on stock option plans for employees and executives must be disclosed.
- Monthly reports must be made on trading of shares and derivatives by insiders.
- The prospectus must include disclosure of risk factors, description of the company’s business and an MD&A among other information.

**Level 2 reporting requirements:**

- Compliance with Level 1 requirements.
- Preparation of annual financial statements according to US GAAP or IFRS. Statements must be filed in English.
- Enhanced rules for corporate governance, including features designed to reduce director entrenchment, voting rights for certain shareholders on key issues and enhanced buyout rights (“tag-along” rights) in the event of the sale of the enterprise.

The results of an initial study conducted on the behalf of BOVESPA indicate that companies that migrated to higher levels on the exchange experience higher share valuations, trading volumes and liquidity, thus supporting the theoretical basis for improved governance in practice.<sup>24</sup> On a more practical level, BOVESPA has come under intense pressure from companies to be more “flexible.” But it has kept the commitments under the Levels and the *Novo Mercado* intact. BOVESPA earned recognition for its firmness when VARIG, the Brazilian national airline, lost its Level 1 listing owing to violations of the listing rules.

Originally, the *Instituto Brasileiro de Governança Corporativa* or the Brazilian Institute for Corporate Governance (IBGC) was somewhat less sanguine about the level of corporate governance that had been set. A survey of 15 Level 1 companies found that, although improving, few companies complied fully with the IBGC code. Today, some two years after the establishment of the *Novo Mercado*, companies have adapted, and the timing is considered good for revisiting and raising the requirements to a higher level.<sup>25</sup>

**Investors, associations and other groups interested in corporate governance**

One of the key impediments to the exercise of greater oversight by investors has been the prevalence of preferred non-voting shares. With no voting rights, Brazilian investors have had limited ability to exercise influence over corporations. Institutional investors have traditionally been passive and foreign investors have also been reluctant to adopt a more active stance. Attitudes are changing as laws and regulations are modified to provide better opportunities for investors to assert their rights. Other groups that defend better corporate governance have maintained a higher public profile and played a more assertive role.

**The National Association of Capital Markets Investors (ANIMEC)**

Minority shareholder interests have been advanced considerably by the *Associação Nacional de Investidores do Mercado de Capitais* (ANIMEC) or the National Association of Capital Markets Investors. Founded in 1999, its objective is to defend minority shareholder interests.<sup>26</sup> ANIMEC seeks to influence all of the key institutions that determine the shape of the Brazilian capital market, including the legislature, the executive and judiciary, as well as the CMV and individual stock exchanges. At present, ANIMEC has not produced any particular statements on disclosure; it appears to pursue an approach of legal activism linked to a strong public awareness campaign.

### **The Brazilian Institute for Corporate Governance (IBGC)**

Other private-sector groups that promote corporate governance are growing in strength and recognition. The best-recognized body is the *Instituto Brasileiro de Governança Corporativa* or the Brazilian Institute for Corporate Governance (IBGC). Originally established in 1995 as the *Instituto Brasileiro de Conselheiros de Administração* or Brazilian Institute of Directors, the new IBGC has broadened its mandate to cover governance. It developed its first code on board practices in 1999, and this was recently revised and enlarged. In April 2001 the new Code of Best Practices of Corporate Governance was completed. The code was the result of broad-based deliberations that included government and the private sector, and it draws some of its inspiration from other well-known international codes. A summary of the key elements that deal with corporate governance disclosure follows:<sup>27</sup>

On disclosure:

- The Chief Executive of the company is responsible for the disclosure of relevant information, whether required by law or not, to all stakeholders.
- The annual report should exceed requirements imposed by law. Financial reports should be prepared according to IFRS or US GAAP. Material changes arising between reporting periods should be immediately disclosed to the public. Company statements should be unbiased.
- Companies should disclose their governance policies in the annual report.
- Remuneration should be disclosed on an individual basis for all executives and directors.
- On selective disclosure, material information should be disclosed to all market participants simultaneously.

On audit:

- The auditor should provide an opinion on the financial statements. The audit should be conducted in accordance with appropriate professional standards. The auditor should assess internal controls and procedures.
- The audit work plan and auditor fees are to be agreed jointly between the board and the audit committee.
- When the auditor provides consulting services to the company, the board must ensure that the auditor remains independent.
- The auditor's clients are the owners, the board and the audit committee.
- Auditors must cooperate fully with the fiscal council and assist in fulfilling its mandate. Auditors may not sit on fiscal councils.
- The auditor must make annual written confirmation of his/her independence to the board.

### **The National Association of Investment Banks (ANBID)**

Intermediaries such as investment banks are actively seeking to promote better disclosure standards. The *Associação Nacional dos Bancos de Investimento* or the National Association of Investment Banks (ANBID) published its Code for Self-regulation for Transactions of Public Placement and Distribution of Securities in Brazil in January 2002. This self-regulatory code sets standards for issuing securities for investment banks and proposes improved transparency in public offerings. It draws some of its inspiration from disclosure standards required by the US Securities

and Exchange Commission and covers both primary and secondary placements. All 60 members of ANBID must comply with the code when conducting their offerings.

**The ANBID code requires disclosure of:**<sup>28</sup>

- Relevant risk factors
- Industry description
- Description of the business
- Management discussion and analysis of the financial statements
- Securities issued in Brazil or abroad
- Pending legal and administrative proceedings
- Related party transactions
- Relationship between the investment bank coordinating the offer and the issuer

ANBID members have the right to indicate that they prepare prospectuses under ANBID rules. By ensuring professionalism within their own industry ANBID members are able to differentiate themselves from the competition and fulfil an important public interest responsibility.

**Companies and industry groupings**

Best practice in governance disclosure in Brazil can be found among companies that are part of Brazil's Corporate Governance Index, which is composed of companies on the *Novo Mercado* and those with higher-level listings on the BOVESPA. At the time of writing, there were two companies listed on the *Novo Mercado*, three companies listed as Level 2 companies on the BOVESPA and 27 Level 1 companies with two additional companies expected.

Among the 30 companies that receive a Level 1 or Level 2 certification from BOVESPA, less than one third have an independent director on the board.<sup>29</sup> While the substance and reporting of governance could improve, companies are reacting to their own needs for capital and the demands of capital providers. A limited number of Brazilian companies are successfully introducing greater independence<sup>30</sup>. *Companhia de Concessões Rodoviárias* (CCR), the first company to be listed on the *Novo Mercado*, recently nominated Ana Novaes as a fully independent member of its board of directors. The company's strategy was to find a board member with financial markets expertise who could contribute to the company and defend the business, rather than defend the interests of one or another group of shareholders. Improvements along the lines suggested by international practices are thus practically feasible.

The other company listed on the *Novo Mercado* is *Sabesp*<sup>31</sup> (São Paulo State Sanitation Company). *Sabesp* is a mixed economy, open capital company that has the São Paulo State Government as its principal shareholder. Approximately 30 per cent is owned by the Government, with the remaining 70 per cent floating freely. The company operates municipal sanitary services under concession. Like CCR it may feel an obligation to be transparent because it provides a public good. Both CCR and *Sabesp* stand out from their peers in terms of disclosure. Both have websites in

Portuguese and English, with financial statements and other CVM filings clearly displayed. Quarterly results and transcripts of analyst meetings are easily accessible. *Sabesp* has won numerous awards in management, including awards related to the sustainability of its operations.

*Aracruz* is another frequently cited example of good disclosure. The quality, speed and transparency of the information that *Aracruz* provides the market have been widely recognized. Two recent examples are the 5<sup>th</sup> Transparency Trophy Prize awarded by ANEFAC (the National Association of Finance, Administration, and Accounting Executives), which ranked *Aracruz* among the five companies in the manufacturing sector with the best financial statements, and the ABRASCA<sup>32</sup> Annual Report Prize, which considered *Aracruz's* annual report one of the three best in Brazil. ABRASCA selected *Aracruz* for outstanding transparency in the areas of analysis of economic-financial factors in its MD&A, information regarding risk, and structures and practices of corporate governance.

Significant improvements in corporate governance at *Marcopolo*, an auto parts manufacturer, also bear mention. In response to discussions with investors, the company decided to rewrite its by-laws to better respond to investor concerns and to seek a Level 2 listing on the BOVESPA. Its new policy of paying close attention to minority investors interests allowed *Marcopolo* to successfully raise additional capital in late 2002 at a time when the Brazilian market was suffering considerable weakness. It has also won it significant praise from market participants.<sup>33</sup>

Best disclosure practices are also visible among companies with Level II and III American Depository Receipts that disclose according to US standards.<sup>34</sup> In September 2001 there were 10, 25 and 44 level III, II and I Brazilian ADRs respectively. One of these companies is *Petrobras*, Brazil's largest integrated oil, gas and energy company. *Petrobras* revamped its financing and governance strategy in order to improve its financial performance compared with a group of peers.

Its new strategy was to align controlling and minority shareholder interests with a focus on profitability with environmental responsibility. Its major steps were a diversification of its shareholder base and enhanced corporate governance, and new by-laws, codes of ethics and rules designed to protect minority shareholders. A special focus was placed on transparency. *Petrobras* now has a website in English, Portuguese and Spanish, which includes SEC filings and other information such as analyst reports and ratings. It conducts webcasts, conference calls and frequent analyst meetings and is working on receiving a level 2 listing on the BOVESPA. *Petrobras* also has a Madrid listing, which it sees (along with its New York listing) as vital in achieving its goal of becoming a world-class energy company.

The Enron crisis, the passage of the Sarbanes-Oxley Act of 2002 and the resulting regulatory changes in the United States were followed closely in Brazil and elicited a lively discussion, in particular among companies listed on US exchanges. The introduction of an independent audit committee, now mandatory in the United States, has been a primary question of interest. While some Brazilian companies such as *Pão de Açúcar* have already introduced audit committees, other Brazilian companies such as *Petrobras* and *Aracruz* would like to see their existing *Conselhos Fiscais* recognized in the United States as audit committees.

One of the principal issues concerns the extent to which Brazilian companies can make their Fiscal Councils independent. US requirements specify that audit committees be composed entirely of independent directors, a demand that would be difficult to meet for Fiscal Councils since controlling shareholders typically nominate a certain number of seats. In addition, the duty to hire and fire the independent auditor resides with the *Conselho de Administração* and not the *Conselho Fiscal*. The extended responsibilities and powers of US audit committees would also inevitably conflict with the requirements for Fiscal Councils found in the Corporate Law. In order to adapt the existing *Conselhos* to new requirements, Brazil might need to modify their responsibilities to include supervision of the independent auditor and communications between the auditor and the board.

*Pão de Açúcar* sees the functions of the *Conselho Fiscal* and the audit committee as being distinct and has, as a consequence, one of each. Its audit committee is composed of three independent directors and a financial expert as required by the Sarbanes-Oxley Act and US listing requirements. Conflicts with Brazilian company law may, nevertheless, remain since the board is legally required to approve the appointment of the independent auditor and not the audit committee.

Brazil's large companies, traditionally resource-intensive and with significant impact on the environment, are also demonstrating increased social and environmental awareness that is reflected in voluntary social disclosures. Many companies now make disclosures on sustainability and environmental impact. Among them are *Sabesp* and *CCR*, noted above. Another example is *Ripasa Celulose e Papel*, a level 1 BOVESPA company. The company discloses basic information on compliance with ISO environmental norms and elements of its corporate citizenship programme. A significant portion of the *Petrobras* website is dedicated to a discussion of social responsibility and the environmental impact of its operations. While these disclosures rarely contain numerical information and, unlike financial statements, are not comparable between companies or over time, the disclosures are important advances.

### C. Implementation issues

The most important market-driven factor encouraging greater transparency in corporate governance is the increasing number of Brazilian companies that are seeking access to the US capital markets via American Depositary Receipts (ADRs). Foreign listings have raised the quality of domestic reporting, but the overall result has been the loss of Brazilian trading volume to US and European markets. In the future, recapturing some of the lost trading volume may mean bringing investors that prefer the relative safety of US or European exchanges back to Brazil.

Another factor that has enhanced transparency has been the opening of the financial markets to international investors. Foreign portfolio investors make greater demands upon companies for information and the disclosures and disclosure policies of some Brazilian companies are clearly being adapted to meet their needs. The absence of voting rights for the vast majority of traded shares still represents a serious impediment to the growth of the Brazilian market and the increased assertiveness of investors.

Enforcement of disclosure regulations is an issue of fundamental importance. The CVM regularly publishes a list of major violations of the organization's

disclosure requirements. In December 2002, 91 companies were on the list with violations going back years. Even though disclosure violations can result in fines and de-listing,<sup>35</sup> companies regularly ignore CVM rules. The inability to have legal recourse in cases where shareholder rights are violated also deters investor activism. Conflicts may take years to resolve and decisions are often subject to multiple appeals. The CVM recognizes that it does not have the powers or the resources to enforce compliance with its determinations.

The effectiveness of voluntary approaches to improving corporate governance has still not been proved. While a lower cost of capital for companies would appear to be a very attractive incentive, so far the private benefits of control in Brazil appear to outweigh the benefits of improved CG such as lower cost of capital. This conclusion appears to be corroborated by the significant premiums paid for control of Brazilian enterprises and the considerable resistance to change from the corporate sector.

Some of the key problems to tackle in the future are old and familiar issues: further improvements to the Corporate Law that would enhance and protect rights of investors; improvements in the adequacy of accounting disclosure; better enforcement mechanisms to ensure compliance; and additional resources for regulatory agencies. Some existing oversight institutions may need to be revamped and others created such as perhaps an independent oversight body for the audit profession. Changes in these areas would likely generate improved standards and practices of accounting and audit, and ultimately improve transparency. Structural changes would also shake the passivity of institutional investors by giving them the incentives and power to act.

## Appendix

<b>Comparison of Brazilian Practice to ISAR Transparency and Disclosure Requirements for Corporate Governance*</b>	
<b>Text of ISAR Requirements</b>	<b>Comparison to Brazilian Practice</b>
<b>I. Financial disclosure</b>	
1. In particular, the group stressed the importance of disclosure of the company's financial and operating results, related-party transactions and critical accounting policies.	<p>Corporate Law and CVM regulation require disclosure of financial and operating results and related party transactions.</p> <p>In its voluntary code of corporate governance, the CVM recommends adoption of IFRS or US GAAP and attestation by an independent auditor. It further suggests including a discussion and analysis of factors that influenced financial results with a focus on risk factors.</p>
2. The group agreed that enterprises should disclose all the financial information necessary for shareholders and other stakeholders to properly understand the nature of their business and how it was being developed for the future. In particular, any accounting policies to which the published results of the enterprise are especially sensitive should be disclosed, and the impact of alternative accounting decisions discussed.	<p>Broadly speaking, all information necessary to properly understand the nature of the business is disclosed. Brazilian law and regulation require annual and quarterly disclosure of financial statements for publicly traded companies. Brazilian accounting standards differ from IFRS in some significant ways.</p> <p>It could not be determined whether accounting policies including a discussion of alternative accounting decisions need be disclosed.</p>
3. The group recognized that enterprises should disclose all related-party transactions and in addition any related-party relationships where control exists. At a minimum, disclosure should be made of the nature, type and elements of the related-party transactions. Even related-	CVM rules require disclosure of related party transactions by reference to IBRACON accounting rules that require disclosure in the notes to the financial statements. The level of disclosure may not be equivalent to that required under IFRS. Related-party transactions must also be disclosed directly to the CVM.

\* The details contained in this comparative table were compiled by a consultant on a preliminary basis. They are also subject to change reflecting possible developments subsequent to the study.

<p>party relationships where control exists, irrespective of whether there have been transactions with parties under common control, should be disclosed. The decision-making process for approving related-parties transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company.</p>	<p>Corporate Law also requires precise information on investments in related companies in the notes to the financial statements.</p> <p>The CVM voluntary corporate governance code recommends that related party transactions be reflected in the financial statements and that they take place in a transparent fashion and under market conditions.</p>
<p>4. Critical accounting policies that are key to the portrayal of an enterprise's financial condition and operating results should be disclosed.</p>	<p>Critical accounting policies are to be disclosed in the notes the company's annual financial statements.</p>
<p><b>II. Non-Financial Disclosures</b></p>	
<p><b>A. Company Objectives</b></p>	
<p>5. The ad hoc consultative group agreed that the objectives of the enterprise should be disclosed.</p>	<p>Corporate Law and regulation require disclosure of the objectives of the enterprise. Disclosure of the objectives is also required for Levels 1 and 2 and the Novo Mercado under BOVESPA requirements.</p>
<p><b>B. Ownership and Shareholders' Rights</b></p>	
<p>6. The ad hoc group recognized that the ownership structure should be fully disclosed to all shareholders. It was also recognized that changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company became aware of them.</p>	<p>Major ownership and voting rights are disclosed. Disclosure of ownership positions in excess of 5% of voting stock is required by the shareholder. Disclosure of the name of beneficiary owners, nationality, number and percentage of common, preferred and total shares, participation in the control of the enterprise including shareholders' agreements must be disclosed. Press announcements by shareowners revealing the purpose of transactions must be made when the 10% threshold is reached and repeated in further increments of 5%.</p>

<p>7. The group took a view that disclosure should be made of control structure and of how shareholders or other members of the organization can exercise their control rights through voting or other means. It also discussed that any arrangement under which some shareholders may have a degree of control disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed.</p>	<p>Major ownership and voting rights are disclosed. CVM recommendations suggest that disclosure should be made of any shareholder agreements, including those to which the company is party. The CVM also suggests release of shareholder information including the number of shares held. In the case a shareholder owns .5% in the company, they are entitled to the contact information of other shareholders.</p> <p>Disproportionate control structures are the rule as opposed to the exception in Brazil. Article 118 of the Corporation Law allows shareholder agreements that may result in disproportionate control. Brazilian law also establishes that 50% of capital may be composed of preferred (non-voting) shares.</p>
<p>8. The group agreed that rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.</p>	<p>Under CVM Rule 299/99, any operation which leads to the selling of the control of shares should be disclosed immediately by the acquiring part to the CVM. Such operations need to be disclosed immediately to the press.</p>
<b>C. Governance Structures and Policies</b>	
<i>The structure, role and functions of the board</i>	
<p>9. The group took the view that the composition of the board should be disclosed, in particular the balance of executives and non-executive directors. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues are not significant and do not impinge on the independence of the directors.</p>	<p>Basic information on the governance structures and policies of the enterprise are disclosed.</p> <p>The composition of the management board and the supervisory board must be disclosed in annual reports including such information as the name, date of election, term, and position. A curriculum vitae is required with information on the director's experience and academic background.</p>
<p>10. The group took the view that board's role and functions must be fully disclosed.</p>	<p>Basic information on the role and function of the board is generally disclosed.</p>

<b>Board committees</b>	
11. The ad hoc consultative group suggested that such governance structures be disclosed. In particular, the group agreed that the board should disclose structures put in place to prevent conflicts between the interests of the directors and management on the one side and those of shareholders and other stakeholders on the other.	While the CVM recommends specific procedures for Brazilian fiscal boards, it does not explicitly suggest disclosure of procedures. Audit committees are recommended but disclosure of information on the committee is not.
12. It was also agreed that the composition and functions of any such groups or committees should be fully disclosed. Where any director has taken on a specific role for the board or within one of these structures, this should be disclosed.	Most Brazilian boards do not have specialized committees. Where they exist general information on their function is disclosed.
<b>D. Members of the Board and Key Executives</b>	
<b>1. Duties and qualifications</b>	
13. The group recommended that the duties of individual directors be disclosed. It was agreed that the number of directorships held by an individual director should be disclosed.	CVM recommendations suggest that the board have at least two members with experience in finance and accounting practices.
14. The experts took the view that there should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfill their responsibilities. There should also be disclosure of the mechanisms which are in place to act as "checks and balances" on key individuals in the enterprise.	Disclosure of a curriculum vitae is required with information on the director's experience and academic background.  Specific disclosure under the rubric of "checks and balances" is not required.
15. There should be disclosure of the types of development and training that directors undergo at induction and on an ongoing basis (continuing education).	No information could be found on requirements to disclose information on development and training.

<p>16. Therefore, the group suggested that the board disclose facilities, which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the year in question.</p>	<p>No information could be found on legislative requirements to provide access to outside advice or any requirement for disclosure that outside advice has been sought. The IBGC code suggests that board members have access to external advice.</p>
<b>2. Evaluation mechanism</b>	
<p>17. The ad hoc group agreed that the board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the valuation are being used.</p>	<p>CVM recommendations suggest evaluations of the performance of the CEO and officers. There does not appear to be any legal obligation to evaluate the performance of the board or make any disclosure of the evaluations. The IBGC code makes this recommendation.</p>
<b><i>Directors' remuneration</i></b>	
<p>18. The ad hoc consultative group took the view that directors should disclose a transparent and accountable mechanism for setting directors' remuneration. Disclosure should be as full as possible to demonstrate to shareholders and other stakeholders that pay is tied to the company's long-term performance as measured by recognized criteria. Information regarding pay packages should include salary, share options and other associated benefits, financial or otherwise, as well as reimbursed expenses. Where share options are used as incentives but are not treated as expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.</p>	<p>The CVM requires disclosure of compensation and profit sharing for directors and company officers in aggregate form.</p> <p>No disclosure of equity ownership is required for directors or executives unless the disclosure is required in the context of owning more than 5% of the voting stock of the enterprise.</p>
<p>19. The group discussed that the length of directors' contracts as well as the nature of compensation payable to any director for cancellation of service contract should be disclosed. Specific reference could be made to any special arrangement that might relate to severance payments to directors in the event of a takeover.</p>	<p>Information could not be found on the legal obligation to disclose compensation in the event of cancellation of a director service contract nor in the event of a takeover.</p>

<b>Succession planning</b>	
20. The group took the view that the board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for sustaining the business. It also recognized that there might be confidentiality issues and that the details of any individual plan should not necessarily be publicly disclosed.	Information could not be found on whether there are requirements to disclose issues regarding succession planning. The IBGC code makes this suggestion.
<b>Conflict of interest</b>	
21. The group suggested that conflicts of interests affecting members of the board should, if they were not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.	<p>The law requires that an officer not take part in any transaction in which he or she has a conflict interest with the corporation. Officers must disclose their disqualification to other officers and shall cause the nature and extent of their interest to be recorded in the minutes of the board meeting.</p> <p>Shareholder agreements must be filed with the company and made available upon request.</p> <p>IBGC code requires disclosure of conflicts of interest.</p>
<b>E. Material Issues Regarding Employees and Other Stakeholders</b>	
22. The group recommended disclosure of whether there was a mechanism protecting the rights of other stakeholders in a business.	<p>Disclosure of material acts or facts are required.</p> <p>To the extent that employee or other stakeholder issues are deemed material, these would need to be disclosed under Brazilian regulation.</p> <p>No information could be found on required disclosure of other stakeholder protection mechanisms.</p>
<b>F. Environmental and Social Stewardship</b>	
23. The group took the view that the board should disclose its policy and performance in connection with environmental and social responsibility	<p>No information on legally required sustainability reporting was found.</p> <p>However, any factors materially</p>

<p>and the impact of this policy and performance on the firm's sustainability.</p>	<p>impacting a company's performance (including social and environmental factors such as, for example, an impending labor action, or costs of an environmental cleanup) would need to be disclosed to the extent that it is material from a financial perspective.</p>
<p><b>G. Material Foreseeable Risk Factors</b></p>	
<p>24. The group took the view that the board should give appropriate disclosures and assurance regarding its risk management objectives, systems and activities. In particular, it was agreed that the board should disclose existing provisions for mitigating the possible negative effects of risk-bearing activities. The board should report on internal control systems and their effectiveness.</p>	<p>Material foreseeable risk factors are disclosed. However, information on board assurances with respect to systems for managing risk could not be found.</p> <p>The CVM recommendations for good governance suggest including a discussion of risk factors in the quarterly and annual financial statements</p> <p>ANBID requirements for prospectuses require a discussion of risk factors.</p>
<p><b>H. Independence of Auditors</b></p>	
<p>25. The group agreed that the board should disclose that it had confidence that the auditors are independent and their integrity had not been compromised in any way. The process for interaction with and appointment of internal and external auditors should be disclosed.</p>	<p>An assessment of current rules would not appear to specifically require that the board disclose that it has confidence in the independence of the auditor, that the auditor's independence is uncompromised or information on the process for interacting with the internal and external auditors.</p> <p>There is, however, a requirement for independent audit. Auditors are appointed and removed by company management boards and are subject to mandatory rotation every 5 years.</p> <p>Limitations exist upon the services that auditors may render to companies, in order to preserve independence.</p> <p>Auditors must relate deficiencies found in internal controls and accounting to management and also to the CVM in case problems are relevant.</p>

<b>III. Annual General Meetings</b>	
<p>26. The group discussed the need for disclosure of the process for holding annual general meetings. Notification of the agenda should be made in a timely fashion, and the agenda should be made available in the national language (or one of the official languages) of the enterprise and, if appropriate, an internationally used business language.</p>	<p>According to article 124 of the Corporate Law, shareholders must be furnished with information on the place, date and time, and the issues to be decided at the meeting. Notice is published at least three times, the first of which must be made public no later than eight days prior to the meeting.</p> <p>CVM recommendations for good governance contain a summary of suggested procedures. 30 days notice is recommended when complex issues are on the agenda. Companies with foreign depository receipts should call meetings 40 days in advance. Meetings should be scheduled in such a manner as not to impair attendance by shareholders. Recommendations also suggest that company by-laws clearly and fairly regulate voting and meeting procedures. Summaries of AGM decisions and meeting minutes are also disclosed the next day or within 10 days respectively.</p> <p>Notices of special shareholder meetings are published in major newspapers according to Corporate Law. Summaries and meeting minutes are disclosed.</p> <p>It could not be determined whether notice need be published in English in addition to Portuguese.</p> <p>The IBGC also supports these recommendations.</p>

## **Brazilian Institute of Corporate Governance: Code of Best Practice of Corporate Governance<sup>36</sup>**

### **3.04. Disclosure**

The CEO must disclose all relevant information, whether or not mandatory, to the owners and stakeholders.

#### **3.04.01 The annual report**

The annual report is the most important and comprehensive source of company information. Therefore, it should not be restricted to information required by law. It should include all aspects of corporate activity throughout a fiscal year, compared with previous years, except those of justifiably confidential matters. The annual report targets a diversified public.

The annual report must contain the opening address by the chair of the board or CEO, the management report, and a set of financial statements complete with the opinion of the independent auditors and the supervisory board, when applicable.

It is up to the management to prepare the annual report and submit it to the board of directors who approves it and subsequently recommends its acceptance or rejection by the general assembly of shareholders.

#### **3.04.02. The Code of Best Practices of Corporate Governance**

The annual report should contain a statement as to what corporate governance practices are being adopted.

#### **3.04.03. Stock ownership and remuneration of board members and directors**

International codes of best corporate governance practices recommend that the annual report specify the stock ownership and remuneration of each of the board members and directors.

#### **3.04.04. Periodic information**

Periodic information on publicly listed companies is regulated by CVM (the Securities and Exchange Commission). Privately held or limited liability companies should do the same, to the extent applicable.

#### **3.04.05. Relevant events**

Unusual events of relevance should be immediately reported to the owners, and, in the case of publicly listed companies, to the stock market, as per CVM regulations.

#### **3.04.06. Transparency**

Company information should be balanced and include both positive and negative aspects, so as to allow the reader to correctly appraise the company.

#### **3.04.07. International accounting standards**

Financial reports should also be prepared according to the IAS (International Accounting Standards) or GAAP (Generally Accepted Accounting Principles).

#### **3.04.08. Simultaneous disclosure and disclosure channels**

All information that may in any way affect investment decisions should be disclosed immediately to all users. The Internet and other information technologies offer interesting opportunities.

### **4. AUDITS – THE INDEPENDENT AUDITORS**

#### **4.01. The independent auditors**

An independent audit is an important instrument of corporate governance for owners of all types of companies, since the auditors' main role is to verify whether the financial statements adequately reflect the company' real circumstances.

#### **4.02. Responsibility**

The independent auditors should give their opinion on the financial statements to be disclosed, in accordance with professional standards, and, for that purpose, assess the company's internal controls and procedures.

#### **4.03. Annual work plan and remuneration agreement**

The independent auditors, jointly with the board of directors or their audit committee, establish their work plan and remuneration agreement. During the first year, the independent auditors will be learning more about the company and will therefore work longer hours than in subsequent years. This fact will naturally be reflected in their fees.

#### **4.04. Contract duration**

It is recommended that, for the sake of their independence, auditors be hired for a specific number of years. They may be rehired after an assessment of their independence and performance, as per legislation and regulations in force.

#### **4.05. Consulting**

The board of directors must ensure that the procedures adopted by the audit firm are independent and objective, especially when the same audit firm provides consulting work. This is an important consideration, since audit work should be hired by the board and consulting is normally hired by the management. If independence is affected, the board should decide as to hiring different consultants or different auditors.

#### **4.06. Relations with the owners, board of directors and Audit Committee**

The owners, board of directors and audit committee are the independent auditors' clients. This establishes the relationship between the parties involved.

#### **4.07. Relations with the CEO and management**

The independent auditors' relations with the CEO, management and other company employees should be strictly professional.

**4.08. Relations with the supervisory board**

The responsibilities of the supervisory board are set forth by Law 6404 of 12/15/1976 (Corporate Law). The independent auditors must cooperate with the supervisory board, so that it may fulfill its mission.

In order to avoid conflicts of interest, the independent auditors should not be members of the supervisory board.

**4.09. Annual statement of independence**

The independent auditors should annually submit a letter to the board of directors confirming their independence.

## **Section 9 of ANBID Code Covering Necessary Disclosure Requirements in Brazilian Prospectuses**

**Section 9** – Whenever acting as Coordinators in public offerings of securities, the Participating Institutions shall comply with the minimum standards established herein and cause the preparation of prospectuses containing, among others, the following information, unless expressly waived by the Brazilian Securities Commission (CVM) or this Self-Regulatory Code:

I – risk factors: description, without mitigation, of any and all factors they may deem relevant, defined as those able to affect their own investment decisions; for the purposes of this item, “mitigation” is defined as any means to alleviate or justify risk;

II – industry information: description of the main aspects regarding the industry where the issuer/offering party is active;

III – activities carried out by the issuer/offeree: (i) description of the business, production processes and active market of the issuer/offeree and that of its subsidiaries; (ii) macroeconomic factors that influence the business of the issuer/offeree; (iii) list of the products and/or services offered by the issuer/offeree and their respective participation (in percentage terms) in the total revenues of the issuer/offeree; (iv) description of products and/or services under development; (v) relationships with suppliers and clients; (vi) dependency relationships in the Brazilian and/or foreign markets; (vii) effects of government actions on the business of the issuer/offeree, and the specific regulations applicable to its activities, if any; (viii) information regarding patents, trademarks and licenses; (ix) material contracts executed by the issuer/offeree and potential effects resulting from any contractual renegotiations; (x) number of employees and human resources policy; and (xi) main competitors;

IV – management discussion and analysis of the financial statements of the issuer/offeree, which shall contain: (i) reasons supporting any changes in the income statement accounts of the issuer/offeree, based on, at least, the last three fiscal years; (ii) reasons supporting any changes in the income statement accounts of the issuer/offeree, based on the last Quarterly Information (ITR) in comparison to the same period of the previous fiscal year, if applicable; and (iii) impacts of inflation;

V – securities issued and/or to be issued in Brazil or abroad, which shall contain: (i) information on the main characteristics of the securities; and (ii) history of price quotation, if any;

VI – pending legal and administrative proceedings: description of any material ongoing legal and/or administrative proceedings, amounts involved, possibility of success and information regarding provisions;

VII – related party transactions: description of any transactions with companies or persons related to the issuer/offeree, including any transactions with the respective controllers as well as with companies associated to or affiliated with, subject to the common control of or that belong to the same economic group of the issuer/offeree;

VIII – relationship with the Participating Institutions acting as Coordinators: description of business relationships with the Coordinators of the public offering.

## Notes

<sup>1</sup> How capital markets growth ranks within the current Government's reform priorities remains to be seen.

<sup>2</sup> Mauro Rodrigues da Cunha, Bradesco-Templeton.

<sup>3</sup> For example, share capital listed on the BOVESPA represented 55 per cent of the Madrid stock exchange in July 1997 and only 6.3 per cent in June 2001. Changes are even more dramatic in relation to other international exchanges. Source: BOVESPA.

<sup>4</sup> Approximation of figures for 2002 provided in BOVESPA's "Overview of the Brazilian Economy and the Capital Market, March 2003". Real/US\$ exchange rates prevailing on 9 May 2003 were applied.

<sup>5</sup> Dispersed ownership tends to be the exception rather than the rule among different securities markets.

<sup>6</sup> Voting shares under Brazilian law were until recently as little as a third (or 33.33 per cent) of total outstanding shares. Absolute control could be maintained with half of the voting shares or less than 17 per cent of the total outstanding shares. This figure was increased to 50 per cent by recent changes to the corporate law, so that now control can be maintained with 25 per cent of total outstanding shares.

<sup>7</sup> Flavio Marcilio Rabelo and Luciano Coutinho, "Corporate Governance in Brazil", April 2001.

<sup>8</sup> The ISAR checklist for best practices on disclosure requirements does not take a position on the desirability of disproportionate control structures. These requirements, however, do support full disclosure of such structures so that investors can better assess the potential risks.

<sup>9</sup> Members of the *Diretoria* are referred to as *directors* in Portuguese (*directeur* in French or *director* in Spanish) but are more properly referred to as executives or officers in English. The translation of the Portuguese word *director* as director in English often leads to confusion with the terms applied to board members.

<sup>10</sup> *Conselhos Fiscais* are sometimes translated as audit committees. This is misleading since they have a different historical origin and fulfil a distinct function.

<sup>11</sup> Similar structures exist in Italy and the Russian Federation.

<sup>12</sup> Heloisa Bedicks, Executive Director, IBGC.

<sup>13</sup> Quarterly statements of listed companies undergo an audit review but no full audit.

<sup>14</sup> Mauro Rodrigues da Cunha, "The Corporate Law: The Beginning of the End," *Jornal Valor*, 24 September 2001.

<sup>15</sup> For the full text of the recommendations in both English and Portuguese, see the CVM website [www.cvm.gov.br](http://www.cvm.gov.br).

<sup>16</sup> International Financial Reporting Standards as established by the International Accounting Standards Board (IASB). For more information on the IASB see [www.iasc.org.uk](http://www.iasc.org.uk).

<sup>17</sup> International Organization of Securities Commissions (IOSCO). The website can be found at <http://www.iosco.org/>.

<sup>18</sup> For more information on IBRACON see <http://www.ibracon.com.br/>.

<sup>19</sup> "GAAP 2001, A Survey of National Accounting Rules Benchmarked Against International Accounting Standards" at: [http://www.ifad.net/content/ie/ie\\_f\\_gaap\\_frameset.htm](http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm).

<sup>20</sup> "GAAP Convergence 2002", at [http://www.ifad.net/content/ie/ie\\_f\\_gaap\\_frameset.htm](http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm).

<sup>21</sup> Delegation is common although it may be difficult to implement in practice. Governments may be cautious about delegating for a number of reasons. Changes in accounting standards can directly affect the tax base. There is often concern about enforcement of private sector standards and possible conflicts of interest within private professional bodies.

<sup>22</sup> The actual requirements state that a tender must be made at "economic value" and establishes methods for its determination. It appears that "economic value" and market value would be equivalent.

<sup>23</sup> For a detailed discussion of BOVESPA listing rules in English see [www.bovespa.com.br/indexi.htm](http://www.bovespa.com.br/indexi.htm).

<sup>24</sup> For a full copy of the report "Effects of migration to Special Corporate Governance Levels of BOVESPA", by Antonio Gledson de Carvalho, January 2003, see <http://www.bovespa.com.br/indexi.htm>.

<sup>25</sup> Heloisa Bedicks, Executive Director IBGC. See below for more on the IBGC code.

<sup>26</sup> The ANIMEC website address is <http://www.animec.com.br/>.

<sup>27</sup> The full code can be found on the IBGC website, <http://www.ibgc.org.br/home.asp>. The sections devoted to disclosure and audit can be found in the appendix to this document.

<sup>28</sup> Section 9 of the code (the principal element that deals with disclosures) is included in the appendix to this document. For a copy of the full code in English or Portuguese see <http://www.anbid.com.br/>.

<sup>29</sup> Source: IBGC.

<sup>30</sup> Some supporters of existing governance structures question the need for independence in the Brazilian context. It is pointed out that the close link between owners and managers in Brazil could in fact be considered a governance ideal since there is no separation of ownership and control. However,

this argument does not take into account the frequent abuse of minority shareholders by controlling groups and the impact that endemic abuse of minority shareholders can have on the credibility of the overall market. Finally, owners and managers are not, in fact, equivalent in Brazil since pyramid structures give control to groups that typically only represent a minority of the capital.

<sup>31</sup> Website: [www.sabesp.com.br](http://www.sabesp.com.br).

<sup>32</sup> *Associação Brasileira das Companhias Abertas* or Brazilian Association of Public Companies

<sup>33</sup> Mauro Rodrigues da Cunha, Bradesco-Templeton.

<sup>34</sup> Brazil has a high proportion of domestic company shares trading elsewhere, with some 37 per cent of its trading volume in the United States. Source: BOVESPA.

<sup>35</sup> De-listings are infrequent, although VARIG, Brazil's national airline, recently lost its Level 1 certification on the BOVESPA.

<sup>36</sup> Only the elements related directly to disclosure are included in this appendix. For a copy of the full code see: <http://www.ibgc.org.br/home.asp>.

## **CHAPTER III**

# **CASE STUDY ON CORPORATE GOVERNANCE DISCLOSURE IN FRANCE**

### **BACKGROUND**

The selection of France as a case study for European corporate disclosure issues can be justified for the following reasons: it is a country from the diversified European geographical, cultural, socio-political and economic landscape; interesting historical background; important asset management framework; high proportion of foreign equity investors; multinational stock market; corporate governance hallmarks; frequently updated corporate governance codes; regularly updated financial legislation; a large number of investment associations and investment clubs; compliance with global accounting standards, and significant disclosure improvements; and France is one of the countries that will adopt by 2005 the International Accounting Standards (IAS) for consolidated financial statements of listed companies.

#### **Geographical, cultural, socio-political and economic backgrounds**

France is positioned at the crossroads of major European cultural influences, between Northern Europe and the Mediterranean. It is also in close touch with both the German and the Flemish cultures and has benefited from the cultural impacts of the emigration mainly from Russia and Poland at the beginning of the twentieth century.

On the political-economic front, the major role played by France, for both the creation and the development of the European Union, is self-evident.

Moreover, France exerts its influence beyond Europe, for example in francophone Africa, in the Middle East, and in many other areas of the world.

#### **Historical background**

The Dutch East India Company – spurred on by the activities of the Hanseatic League in Germany, the Netherlands and Belgium – contributed as early as 1602 to the creation of the Amsterdam stock exchange. The English East India Company followed closely the establishment of the Dutch company.

The Compagnie Française des Indes, was founded only in 1664, half a century after the foundation of its Dutch and English counterparts.

In France, the first securities are reported to have been traded around 1709 at the Hôtel de Soissons. After John Law's bankruptcy, the first stock market started operating in 1720, moving to the Palais Brongniart in 1807. The latter is now used as

a conference centre by Euronext-Paris, which relies exclusively on electronic trading and is based at 39 rue Cambon, Paris 8e.

### **Important asset management framework**

France is reported to be the fourth asset management market in the world (for both equity and fixed income funds), totalling some EUR 1,5 trillion in December 2002. It is also the first mutual funds market in Europe, and the second in the world, with about EUR 850 billion, during the first quarter of 2003 (for both equity and fixed income assets).

The interest in equity investments is growing, as demonstrated by the fact that there were 7 million individual French shareholders in 2002 (after a high of 8 million in 1920 and a low of 1.3 million in 1978). This number represents about 11.5 per cent of the French population, versus higher comparable figures for the United States (26 per cent), and the U.K. (22 per cent). In Germany, it is 8 per cent.

### **High proportion of foreign equity investors**

While only about 11 per cent of the French stock exchange capitalization was owned by investors located outside France in 1986, that proportion is reported to have jumped to 36 per cent in 2001.

According to a Georgeson shareholder survey, – quoted in *Le Monde* of 6 June 2002, non-resident shareholders exceed the majority in several French companies, for example:

#### **Foreign investors' majorities in France**

TotalFinaElf	65.0%	Lafarge	58.5%	Suez	52.0%
Aventis	60.0%	Vinci	56.0%	Saint Gobain	51.0%

Moreover, foreign investors often tend to generate as much as 80 per cent of the French stock market transactions.

The main reasons for this relatively high proportion of foreign investors are the weak equity market participation of both French pension funds (which generally adopt the “pay as you go” approach, devoid of equity capital) and French individual investors, as well as the successful international promotional drive of the Paris Bourse/Euronext exchange over the past decade.

Most large-cap French companies take into consideration this important foreign shareholder factor by publishing their reports both in French and in English.

### **Multinational stock market**

In 2003, the Euronext Stock Exchange is considered to be the leading European stock market consolidator, after the merger of the Paris Bourse with the

Belgian, Dutch and Portuguese exchanges. Moreover, it relies on the Euroclear unified European securities trading settlement infrastructure covering France, Belgium, the Netherlands, Portugal, the United Kingdom and Ireland. Furthermore, the London-based Euronext.liffe derivatives exchange is in partnership with the Chicago Board of Trade and the Chicago Mercantile Exchange in the United States.

Euronext ranks first for trading volumes, and a close second to the London Stock Exchange, in terms of market capitalization and number of listed companies in Europe.

Euronext has developed two upgraded corporate segments: NextEconomy and NextPrime. To be admitted, companies must be continuously traded. They should also offer the following disclosure characteristics: bilingual reliance on English and one national language (French, Dutch or Portuguese) in financial publications; annual report issued within three months; adoption of, or reconciliation with, IAS; corporate governance policy statement; publication of disclosure timetables; at least two analysts' meetings per annum; release of information to investors via the Internet; and publication of information on their shareholders.

Paris Bourse, chaired by Mr. Jean-François Théodore, enhanced its international positioning in 1995 with the creation of its International Advisory Board composed of leading global (non-French) investors and highly qualified international corporate governance experts. This Board is now a Euronext Board.

Moreover, the French financial market place has also been promoted for a decade by Paris Europlace, with over 200 institutional members. It organizes each year in July an International Financial Forum, which brings together some 1,500 financiers from all over the world.

### **French corporate governance hallmarks**

France can be considered to be in the forefront of continental European corporate governance developments. Paris Bourse took, for instance, the initiative to invite the International Corporate Governance Network (ICGN) to hold in 1997 its Third Annual Conference in Paris, right after Washington DC and London. The successful outcome of this 1997 Conference prompted Euronext to invite the ICGN to hold its Ninth Conference in Amsterdam in 2003.

Another pioneering example of French corporate governance initiatives is provided by the first multinational quantitative corporate governance and shareholder value driven equity mutual fund ever launched in the world: the ABF Europe Valeur Actionnariale (Shareholder Value) index tilted mutual fund, which was launched in Paris in January 1998. This fund - managed by ABF Capital Management, with data computed by the French proxy voting advisory firm Proxinvest according to an algorithm developed by Geneva-based corporate governance expert and ICGN co-founder André Baladi - significantly over-performed its European Union benchmark for several years.

## **French corporate governance codes**

Five French codes, or reports, have been published between 1995 and 2003:

- “The Board of Directors of Listed Companies in France”, published on 10 July 1995 by the AFEP – CNPF Committee,<sup>1</sup> chaired by Mr. Marc Viénot, Chairman at that time of the Société Générale Bank. This report is known in corporate governance circles as the “Viénot I Report”.
- “Recommendations on Corporate Governance”, published on 9 June 1998 by the AFG-ASFFI Commission,<sup>2</sup> chaired by Mr. Jean-Pierre Hellebuyck, Strategic Investment Manager of AXA in Paris. This report is known in corporate governance circles as the “Hellebuyck I Report”.
- “Report of the Committee on Corporate Governance”, published in July 1999 by the AFEP-MEDEF Committee,<sup>3</sup> chaired by Mr. Marc Viénot, then Chairman of Paris EuroPlace. This Report is known in corporate governance circles as the “Viénot II Report”.
- “Recommendations on Corporate Governance”, updated edition of the 1998 AFG-ASFFI Commission chaired by Mr. Jean-Pierre Hellebuyck, published on 23 October 2001. This report is known in corporate governance circles as the “Hellebuyck II Report”.
- “Promoting Better Corporate Governance in Listed Companies”, published on 23 September 2002 by the AFEP/AGREF-MEDEF Committee,<sup>4</sup> chaired by Mr. Daniel Bouton, Chairman of the Société Générale Bank.

A combined Code (Viénot I and II and Bouton) is scheduled to be published in 2003.

French companies strive to adopt the principles of the above five French codes or reports. They are often mentioned in corporate annual reports. The ICGN and / or the OECD International Corporate Governance Codes are also sometimes referred to.

## **Financial legislation**

French financial legislation is periodically updated according to requirements.

The New Economic Regulations (Nouvelles Régulations Economiques – NRE) law was approved on 15 May 2001. It contains several clauses referring to corporate governance disclosure issues, which are largely inspired by both the Viénot I and II and the Hellebuyck I Codes (the Hellebuyck II and the Bouton Codes were not yet published then) – for example, reduction of the number of Board Directors

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<sup>1</sup> AFEP: Association Française des Entreprises Privées  
CNPF: Conseil National du Patronat Français

<sup>2</sup> AFG: Association Française de Gestion Financière  
ASFFI: Association Française des Fonds et Sociétés d’Investissements

<sup>3</sup> AFEP: Association Française des Entreprises Privées  
MEDEF: Mouvement des Entreprises de France, the new name of the CNPF

<sup>4</sup> AFEP: Association Française des Entreprises Privées  
AGREF: Association des Grandes Entreprises Françaises  
MEDEF: Mouvement des Entreprises de France, the new name of the CNPF

from 24 to 18, disclosure of the remuneration of Chief Executives, social and environmental reporting, and identification of important shareholders.

Moreover, a new Financial Security Law (Loi de Sécurité Financière) was submitted for the approval of the French Parliament on 21 March 2003. It will create a new Financial Markets Authority (Autorité des Marchés Financiers – AMF) through a merger of the Stock Exchange Commission (Commission des Opérations de Bourse – COB) with the Financial Markets Council (Conseil des Marchés Financiers – CMF). The future Financial Markets Authority will carry out the activities of its parents, including the monitoring of auditing practices.

This new law will cover a wide range of issues, for example auditing (new Auditors’ Supervisory Board, regulation of auditing and auditors) and corporate governance disclosures.

For several decades now French companies have been compelled by law to update their financial disclosures in the official BALO (Bulletin des Annonces Légales Obligatoires) publication. Listed companies must be audited by two auditors from two different audit firms performing their mission jointly.

Since 1993, the COB has published updated French laws and regulations in its financial “vade mecum”, which can be consulted on the Web under “Transparence du marché”.

### **Large number of investment associations and clubs**

France has a number of associations, which happen to be involved with corporate governance disclosure issues – for example, Association for the Defence of Minority Shareholders (Association Française pour la Défense des Actionnaires Minoritaires – ADAM), Association of French Pension Funds (Association Française des Fonds de Pension – AFPEN), National Association of French Shareholders (Association Nationale des Actionnaires Français – ANAF), French Association of Joint Stock Companies (Association Nationale des Sociétés par Actions – ANSA), Association of Small Minority Shareholders (Association des Petits Porteurs d’Actifs – APPAC), Association of Employee Shareholders (Association Volontaire des Actionnaires Salariés – AVAS), Council of Financial Communication Advisers (Cercle de Liaison des Informateurs Financiers en France – CLIFF), Federation of Employee Shareholders’ Association (Fédération des Associations d’Actionnaires Salariés et Anciens Salariés – FAS), Paris Europlace (see above), and French Financial Analysts Society (Société Française des Analystes Financiers – SFAF).

Moreover, France appears to have pioneered in Europe the development of “Shareholder Clubs” (Clubs d’Actionnaires). Several French companies have set up such clubs. They offer a wide range of benefits : privileged telecom access, shareholder letters, websites, training programmes, specific publications and company tours (plants, distribution centres, etc), as well as meetings, during which critical corporate issues can be debated informally.

### **Compliance with global accounting standards, and significant disclosure improvements**

The leading US corporate governance advisory firm, Davis Global Advisors, has ranked countries according to whether they comply with the two predominant accounting standards in the world, IAS and Generally Accepted Accounting Principles (GAAP), either US or UK. According to the November 2002 Davis Global Advisors report, "Leading Corporate Governance Indicators" (released at a meeting of the International Advisory Board of Euronext), 33 per cent of the top 250 French companies relied on either IAS or GAAP, compared with 100 per cent in the United States, 90 per cent in the United Kingdom (based on UK GAAP equivalence), 71 per cent in Germany and 56 per cent in the Netherlands. Other countries ranked less than France, thus positioning the latter in the medium range.

The same pattern is reported in a Standard & Poor's ranking, released in April 2003. British, French, and Dutch corporations rank best, after US companies, for global standards of corporate governance information disclosure. While European companies rank consistently high on disclosure in annual reports and on financial information, they tend to trail US companies in disclosing ownership information and investor rights.

According to Mr. Pierre-Henri Leroy, President of the French proxy voting firm Proxinvest in Paris, French corporate disclosures have significantly improved since the publication of the Viénot I Report in 1995: for example, most annual reports are now forwarded to shareholders at least two weeks before Annual General Meetings; the background of Chief Executives, as well as their remuneration (including stock options), is now disclosed; the performance of Board Committees is increasingly reported; and the breakdown between auditing fees and advisory fees of auditors is communicated to shareholders.

### **The French accounting system and IAS**

The French accounting system, which derives from the "double-entry" system described in 1494 by Friar Luca Bartolomeo Pacioli in Venice, is due to be impacted by the adoption of IAS for the consolidated accounts of stock exchange listed companies throughout the European Union by 2005, and perhaps ultimately for all European companies.

In 2003, French accounting principles are based on the Business Code (Code de Commerce); the rules of both the General Accounting Plan (Plan Comptable Général) and the Committee of Accounting Regulation (Comité de la Réglementation Comptable); the recommendations issued by the National Accounting Board (Conseil National de la Comptabilité); and the interpretations of the Urgent Issues Committee (Comité d'Urgence), as applied to consolidated financial statements.

The Institute of Public Accountants and Authorized Accountants (Ordre des Experts Comptables) issues recommendations to assist its members in the application of accounting legislation and regulations.

As previously stated, the new Financial Markets Authority (Autorités des Marchés Financiers – AMF) is scheduled to issue recommendations and opinions on auditing practices.

A comparative list of French accounting rules and IAS rules can be found in *inter alia*, the GAAP Series *Surveys of National Accounting Rule in 53 Countries*. France is also one of the 59 countries surveyed in the study *GAAP Convergence 2002*.

Pending convergence issues between the French accounting system and IAS are discussed in the next section.

## I. FINANCIAL DISCLOSURE

In 1988, the French Financial Analysts Society (Société Française des Analystes Financiers – SFAF) published its Code of Ethics. It was updated in 1992 in cooperation with the French Council of Financial Communication Advisers (Cercle de Liaison des Informateurs Financiers en France – CLIFF), and in 2002 in cooperation with the Financial Markets Council (Conseil des Marchés Financiers – CMF). These Codes highlight the need to ensure the equal treatment of all shareholders regarding the release of corporate information. They also prohibit the use of insider information for personal enrichment, and set up procedures to prevent conflicts of interests within the financial analysts profession.

The 1995 and 1999 Viénot I and II Reports were more focused on corporate governance than on financial disclosure. They emphasize the need for directors to be well informed, to respect their duty of professional secrecy, and to refrain from trading on securities on the basis of insider information. They also emphasize the necessity to accelerate the publication of consolidated annual accounts.

The 1998 Hellebuyck I Report focused on the release of information via different means – for example, two reports, one in summary form and the other more complete; reports should also be communicated via electronic means in both French and English; and publication of executive compensation, including the method of calculation of stock options and severance pay, if any.

The 2001 NRE Law legalized several recommendations of the above Reports.

The 2001 Hellebuyck II Report updated its 1998 voting recommendations with a chapter on sustainable development, as well as on encouraging companies to consider separating the functions of Board Chair and of CEO, and releasing more information on executive remunerations.

The 2002 Bouton Report stresses the supremacy of substance over form, and enshrines the “true and fair view” principle. Annual reports should identify off-balance sheet commitments (in a note to financial statements). Market risks (exchange rates, credit, commodities, etc) should be clarified. In-house procedures to assess such risks should also be communicated, with sensitivity risk indicators and the method to evaluate the latter. Moreover, the Report states that updated ratings of financial agencies should be disclosed.

The Bouton Report also favours increased convergence between the US GAAP and the IAS/IFRS accounting systems. However, it considers that the IAS approach requires improvements, for example:

- It should attempt to reduce its excessive short-term focus.
- Fair value accounting should take into account holding periods and management processes, particularly for long-term assets and liabilities.
- It should better clarify and harmonize the information used. With the inflation in data requirements, standard-setters should focus on key items of greatest interest to users.
- It should clearly define the core principles concerned and the approach relied upon, avoiding overly detailed and complex rules.

In a nutshell, the Report hints that the IASB's working procedures need to better take into consideration the views expressed by all economic players, and more particularly by issuers, investors and auditors.

An important IASB issue concerns the IAS 39 rule on derivatives. French bankers are reported to have joined the efforts of the European Banking Federation aimed at persuading the IASB to amend its proposed IAS 39 rule on derivatives, because of fears that these rules may threaten the widely used risk-management strategy known as macro hedging. Future negotiations will clarify how the IASB will manage to keep to its objective of reducing hidden derivative exposures on corporate balance sheets.

Meanwhile, according to the 3 June edition of the French daily *Le Monde*, the European Union recommended that the application of both the IAS 32 and IAS 39 rules be suspended, for fear that the "fair market value" concept, which risks being promulgated by these rules, might stir up balance sheet volatility. According to the 23 June 2003 edition of *The Wall Street Journal Europe*, the IASB may tweak its proposed rules on derivatives. The July 2003 issue of the *World Accounting Report* states that the IASB had worked out arrangements with European banks and was in the process of finalizing the amendments to the two Standards.

While the advent of the IAS will represent significant progress, another major hurdle to overcome in the future will be harmonizing the US GAAP accounting rules with those of the IAS. In the past, several French companies reported huge discrepancies between the French accounting system and the US GAAP (e.g. France Télécom in 2001).

In any event, leading global pension funds, together with other institutional investors, have often expressed the view that a quick resolution of all dissension is required among all concerned parties, so as to allow investors to benefit from a single global accounting and reporting system. Such a global convergence would significantly facilitate the worldwide benchmarking of companies within their respective industrial sectors.

How are the French companies reacting to this avalanche of laws, codes and reports?

According to the Paris based Proxinvest, which monitors French companies, the latter strived to improve their financial disclosures during the 2001-2002 proxy seasons, for example:

- Lagardère, where a distinction is now made between: internal financial ratios (i.e. Net Operating Profit after Tax, at standard tax rates, related to the Cost of Capital), and external financial ratios (i.e.: Total Shareholder Returns).
- Accor, which computes its Economic Value Added-EVA© - ratio.
- Cap Gemini and Schneider, with operating results broken down by business segments and geographical areas.
- Total, where the 2005 forecasts of their Return on Average Capital Employed are broken down by business segments.
- Saint Gobain and Sodexo, where liabilities are accounted in great detail.

## II. NON-FINANCIAL DISCLOSURE

### A. Company objectives

None of the five French Reports requires that corporate objectives be communicated, as a result of which few French companies highlight their corporate objectives.

The Viénot I Report statement that corporate objectives should focus on “the company’s interest”, as opposed to shareholder value interests, stirred a row with certain Anglo-Saxon governance professionals. The debate has abated since 1995, owing to the emergence of corporate social responsibility concerns.

### B. Ownership and shareholders’ rights

The French Reports are silent on shareholder structure disclosure. This could be explained by the fact that the Conseil des Marchés Financiers (CMF) requires corporations to announce that the following thresholds of either the investor’s share capital or voting rights have been crossed (downward or upward): 5 per cent, 10 per cent, 20 per cent, 33 per cent, 33.33 per cent, 50 per cent, 66.66 per cent. The 2001 NRE Law also requires that share ownership be disclosed by the securities custodians.

The Hellebuyck II Report highlights the “one share, one vote” principle and its disapproval of the practice of non-voting stocks.

Actually, the “one share, one vote” principle now tends to be widely implemented in France, with the exception of very few companies, which are shielded by voting right caps, for example: Vivendi Universal (2 per cent), Danone (6 per cent), Alcatel (8 per cent), Total (10 per cent), and Société Générale (15 per cent).

The widespread French practice of double voting rights, which reward the loyalty of holders who keep their shares beyond a certain allotted time, is criticized by the Hellebuyck Reports, which consider that this practice could lead to the abuse of expanding the control of a company by its minority shareholders. The Reports

therefore recommend that the double voting rights procedure be abolished, except during the first five years of a company's initial public offering.

According to Proxinvest, several French companies released in 2002 more information than is required by the 2001 NRE Law, for example: Danone, Société Générale and Suez, which disclosed the names of shareholders exceeding 1 per cent of their share capital.

When the 2002 Bouton Report encouraged several companies to provide a wide array of information on, among others, the composition of Corporate Boards, their charters and the biographies of their members, a number of companies complied, for example: Air Liquide, BNP Paribas, Renault, Schneider, Société Générale and Sodexo.

The traditional opacity of French remuneration disclosures was particularly superseded at AXA, Club Méditerranée and Schneider, with disclosure standards detailing both the fixed and the variable remunerations (including stock options). EADS now provides a detailed calculation of the retirement benefits of the members of its Executive Committee.

Significant progress was also achieved in 2002 regarding earlier release of Annual Reports, particularly at Air Liquide, Alcatel, Aventis, BNP Paribas, Bouygues, Danone, Klépierre, France Télécom, Michelin, Péchiney, Pinault-Printemps-Redoute, Rhodia, Valeo and Vivendi Universal.

### **C. Governance structures and policies**

#### **1. The structure, role and functions of the Board**

The Viénot I Report emphasizes that the Board, regardless of how it is structured, must act as a collegial body representing all shareholders.

The Bouton Report recommends that the minimum proportion of independent Directors be set at half the number of Board members, particularly for companies with dispersed ownership.

One of the main issues, debated in France by the Viénot, Hellebuyck and Bouton Reports, concerns the separation of the Board Chair function from the Chief Executive function. Actually, France is similar to the United States, with both functions cumulated in about 20 per cent of the companies by the Chairman and CEO (Président Directeur Général-PDG).

The French Commercial Code allows French companies to choose between three choices:

Joint PDG function, adopted by the majority of companies;  
Separation of the two functions;  
Adoption of the two-tier German model of a Supervisory Board (Conseil de Surveillance) and a Management Board (Directoire).

On the mission of the Board, the Viénot I Report states that “the Board defines the company’s strategy, appoints the corporate officers responsible for managing the company and implementing this strategy, oversees management, and ensures the quality of information provided to shareholders and to financial markets through the financial statements or at the time of very important operations”. This definition is now implemented in the French Commercial Code.

## 2. Board committees

The Viénot, Hellebuyck and Bouton Reports stress the importance of the three key Board Committees:

- Remuneration Committee, which should set both the fixed and the variable portions of corporate officers’ remuneration;
- Nominating Committee, responsible for ensuring management nominations and succession plans;
- Audit Committee, empowered with increased responsibilities for checking critical corporate auditing issues.

The Bouton Report highlights the importance of these three key Committees, which should be composed exclusively of independent Directors, for both the Remuneration and the Nominating Committees, and with a two-thirds majority of independents for the Audit Committee. Their activities should be summarized in the Annual Report.

According to Proxinvest, while in 2002 74 per cent of the French companies members of the SBF 120 had both Remuneration and Audit Committees, only 11 per cent had a Nominating Committee, compared with 82 per cent in the United Kingdom for example.

## **D. Members of the Board and key executives**

### 1. Duties and qualifications

Both the Viénot II and the Hellebuyck I Reports outline the first French Directors’ Charter of Rights and Obligations:

- Directors should strive to be aware of the obligations entailed by their mission.
- They should personally own a significant number of the company’s shares (e.g. worth one year of directors’ fees).
- They must devote the necessary time and attention to their duties, and should not accept more than five directorships (this limitation was confirmed by the NRE 2001 Law).
- They must endeavour to attend all Board meetings.
- They must ensure that they are properly informed, by requesting additional information whenever required.
- They should consider themselves bound by a duty of professional secrecy.
- They should refrain from trading in the securities of companies, on the basis of their privileged insider information.

The Viénot II Report recommends limiting the terms of directorships to four years.

According to Proxinvest, these recommendations have already been adopted by most large cap French companies.

## 2. Evaluation mechanism

The Viénot Reports emphasize the need to assess Board performance.

The Bouton Report recommends an annual operational review, supplemented every three years by a formal review, with the possible contribution of an external consultant. Shareholders are to be informed in the Annual Report of the evaluations and, if applicable, of any steps taken as a result. The Report also recommends annual Board meetings without “in-house” Directors.

According to the Bouton Report, very few French Boards have implemented such an exhaustive evaluation procedure.

## 3. Directors’ remuneration

In this section, the term “Director” means both Board Directors and Senior Corporate Executives.

In 1999, the Viénot II Report recommended the disclosure of the remuneration (including stock options) of top executive teams in Annual Reports, so as to allow shareholders to check whether it was tied to the performance of senior corporate management.

Later, when the MEDEF recommended such voluntary disclosures, several French Chief Executives obliged.

Since 2001, French law has issued the following stock option prescriptions:

- The Annual General Meeting has the exclusive power to authorize the granting of options.
- The exercise price of the options, based on stock prices at the time of granting, cannot be revised afterwards.
- The holding period of options, fixed by tax rules, is four years so as to restrict possible short-term management behaviours.
- Directors who are neither corporate officers nor employees are not entitled to stock options.
- Companies are prohibited from making loans to their executive managers or directors, either for options or for any other purpose.

Such provisions contribute to preventing many previous abuses.

The Bouton Report recommends the rejection of discounts when granting options to corporate officers and executives.

It also recommends that options be granted at set intervals in order to avoid opportunistic granting of options during an exceptional drop in stock prices. The

policy defined by the Board of Directors should distinguish between corporate officers, executives and other grantees.

Moreover, the Bouton Report favours “purchase options” over “subscription options”. While the former may entail a cost for the company if recognized as an expense, the latter risk having a diluting effect for shareholders. Remuneration Committees should inform Boards for the reasons justifying the choice, and the consequences, of the adopted options system.

The issue of severance payments for cancellation of service contracts, in the event of a takeover for instance, is addressed by the Hellebuyck II Report, which considers that severance payments should be modulated according to corporate performance during each executive’s respective years of service.

The MEDEF Ethics Committee published in May 2003 a series of recommendations on corporate remuneration.

#### 4. Succession planning

As in most other continental European countries, succession planning is not considered sufficiently developed in France.

According to both the Viénot I and II Reports, it is the responsibility of the Nominating Committee of the Board to appoint its Chairman, Board of Directors, Chief Executive Officer and other senior management officers.

The Bouton Report recommends that the selection process be published in the Annual Report.

#### 5. Conflicts of interest

The Bouton Report states that “A Board Director is independent when he or she has no relationship of any kind whatsoever with the corporation, its Group, or the management of either, that is such as to colour his or her judgement”. It also lists independence criteria, including that the director should not be an employee or corporate officer of the company, its parent company or consolidated subsidiaries, and has not been one during the previous five years; the director is not (directly or indirectly) a customer, supplier, investment banker or commercial banker; the director does not have any close family ties with a corporate officer of the company; has not been an auditor of the company over the past five years; and the director has not been a director of the company for more than 12 years.

### **E. Material issues regarding employers and other stakeholders**

The French system does not incline towards co-determination on the German model. French unions prefer to leave the power of decision with corporate management, while focusing on collective bargaining.

However, the French Corporate Committees (Comités d’Entreprise), on which the workforce and/or unions are represented, delegate one or two members – without voting rights – to Board meetings. Employee members with voting rights are

considered if 3 per cent or more of the capital is held by employees. Under the 3 per cent ratio, this requirement is optional.

This formal framework can be supplemented by consultations with the workforce and/or unions on fundamental changes, such as structure, closures, expansion or diversification.

Moreover, several companies have instituted important employee shareholding programmes. According to the study published in the 19 November 1999, issue of *La Vie Financière*, the stake held by such programmes amounted to 5 per cent of the total capitalization of the Paris Bourse.

The French Federation of Employee Shareholders' Associations (Fédération des Associations d'Actionnaires Salariés et Anciens Salariés – FAS) has developed an Index of Employee Shareholders (Indice de l'Actionnariat Salarié – IAS) of the companies in which 3 per cent or more of the capital is held by employees. In 1999, for example, the following 28 French companies had employee shareholder programmes owning 3 per cent or more of their capital:

**COMPANIES WITH HIGH EMPLOYEE SHAREHOLDER OWNERSHIP**

	%		%		%
AGF	3.4	Elf Aquitaine	5.0	Schneider	3.5
Air France	11.4	Essilor International	17.9	SEB	3.8
BNP	3.2	France Télécom	3.6	SEITA	6.3
Boiron	3.2	Gascogne	5.5	SIDEL	7.2
Bouygues	6.0	Guerbet	5.7	Société Générale	8.6
Brioche Pasquier	7.3	Latécoère	5.7	Technip	3.0
Bull	5.4	Renault	3.2	Total	2.9
Castorama-Dubois	4.0	Rhône-Poulenc	3.8	Usinor	3.6
Crédit Lyonnais	5.0	SAGEM	27.0	Vivendi	3.0
Eiffage	23.0	Saint-Gobain	3.7		

**F. Environmental and social stewardship**

The 2001 NRE Law compels French companies to report the impact of major environmental and social issues on their activities, for example:

- Remuneration, including social charges;
- Dismissals, particularly those resulting from corporate restructurings;
- Water and energy consumption;
- Pollution concerns;
- Reliance on environmental and social certifications.

The Hellebuyck II Report stresses the importance of corporate long-term sustainable development principles.

According to Proxinvest, questions raised on both social and environmental issues are increasing at French Annual General Meetings. In 2002, they represented respectively 23 per cent and 5 per cent of all questions raised at the AGMs of CAC 40 listed French companies.

France is also one of the very few countries which created in 2002 a high-level State Secretariat in charge of sustainable development.

Moreover, following similar developments in other countries, about 50 social and environmental equity funds were developed in France between 2000 and 2003. These funds are based on the scoring systems of both French and foreign environmental and social corporate scoring firms.

#### **G. Material foreseeable risk factors**

The Bouton Report states that the members of the Audit Committee should examine material risks and off-balance-sheet commitments, interview the Chief Financial Officer and the head of the internal audit, and express their view on the organization of the audit department.

#### **H. Independence of auditors**

According to the Viénot II Report, the Audit Committee should clarify all possible risks of conflicts of interest between the “*stricto sensu*” auditing work and the consulting services provided by auditors.

According to the Bouton Report, “the statutory auditing should be carried out to the exclusion of all other work for the client company. The audit firm that has been retained should give up, for itself and for the network that it belongs to, any consulting work (e.g. legal, tax or information technology consulting) that it has provided directly or indirectly to the company it has been selected by, or to its Group”.

The dual auditorship – which may be a specific feature of French accounting – contributes to ensuring the independence of auditors.

The Bouton Report recommends that auditors be rotated every six years via tenders.

### **III.ANNUAL GENERAL MEETINGS**

The Hellebuyck Reports recommend that the delay between the closing of a company’s annual accounts and the Annual General Meeting be limited to a maximum of four months.

The Reports also recommend that the period for calling the Annual General Meeting be extended beyond 15 days to up to one month, so that the documents can be delivered to the shareholders sufficiently in advance of the meeting. They also recommend the publication of two reports: an oversimplified one to be dispatched to all shareholders, and a more exhaustive one to be communicated to shareholders upon request.

The reliance on English as the second reporting language is spreading rapidly in France, as a result of the NextEconomy and NextPrime labels initiatives of Euronext.

The traditional French procedure of “blocking stocks” up to five days before Annual General Meetings was criticized by the Hellebuyck II Report, by Proxinvest and by many investor groups. The NRE Law strived to improve the “blocking system”, by authorizing shareholders to sell their stocks up to 3 p.m. on the day preceding the Annual General Meeting, provided that they release the information allowing the cancellation of their votes, should the latter be required.

Actually, in 2003, the main problem confronting international investors in France is Chapter V of the 2001 NRE Law, on the “Identification of Foreign Holders”. It sets up a secret identification process between foreign investors and Board Chairs. It also compels foreign holders to renew their “voting mandate”, with their original signature, for each Annual General Meeting. This NRE Law<sup>5</sup> was criticized, among others, by Proxinvest and by Senator Philippe Marini, Rapporteur of the French Senate Finance Commission, as being much too complicated and discriminatory towards foreign holders, as well as granting excessive powers to Board Chairs for cancelling the voting rights of “non-adequately identified” investors.

Several solutions have been proposed by Proxinvest, and by various professional bodies and renowned experts, so as to avoid the problems created by this 2001 NRE Law identification process.

The French AFG-ASFF Association, Proxinvest and Professor Jaap Winter – Chairman of the European Commission’s High Level Group of Company Law Experts – have for instance recommended that the entire network of banks and other securities intermediaries be entitled to certify voting rights (as opposed to the corporate control of the 2001 NRE Law) on behalf of specific instructions, and/or valid powers of attorneys, from the ultimate account holders.

The “Identification of Foreign Holders” promulgated in the 2001 NRE Law is rather surprising in a country considered a pioneer in the continental European financial securities field. This contested foreign voting issue is likely to be resolved in the future, for the benefit of both foreign holders and the French financial market place.

#### **IV. TIMING AND MEANS OF DISCLOSURE**

Since 1987, the Commission des Opérations de Bourse (COB) has encouraged French companies to report in a Reference Document (Document de Référence) detailed financial information aimed at financial analysts and institutional investors. It should be released to the COB at least 50 days before the Annual General Meeting, while the Annual Report should be submitted to the COB 30 days before the AGM. About 350 French companies publish the Reference Documents.

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<sup>5</sup> Implementation Decree (Décret d’Application) 2002-803, 3 May 2002

## **V. BEST PRACTICES FOR COMPLIANCE WITH CORPORATE GOVERNANCE**

Since the Viénot I Report, French listed companies state their compliance with one, or several, or the latest published French Code(s) in their Annual Reports.

## **VI. CONCLUSIONS**

Institut Montaigne, the influential think tank founded by Mr. Claude Bébéar, Supervisory Board Chairman of AXA, concluded its March 2003 publication “Mieux Gouverner l’Entreprise” by stating that corporate governance regulations should be adapted to changing conditions.

The history of French corporate disclosure has so far demonstrated that the system is not cast in stone but has a resilient capacity for reform, confirmed by the impact of the proliferating French, European Union and other international laws, codes and reports, which evolve according to rapidly changing socio-political, legal, regulatory, economic, financial and environmental conditions.

Last but not least, most French corporate disclosure principles, practices and policies tend to be upheld by the initiatives of the European Commission in Brussels. The latter is for instance negotiating, on behalf of all EU members, exemptions from the US Sarbanes-Oxley Act.

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## **CHAPTER IV**

### **CASE STUDY ON CORPORATE GOVERNANCE DISCLOSURES IN KENYA**

#### **I. BACKGROUND**

Kenya, the gateway to East Africa, is strategically located on the Indian Ocean coast, thus providing easy access to regional and world markets. It borders Somalia, Ethiopia, Sudan, Uganda and the United Republic of Tanzania. It is aptly described as a land of contrasts, with 582,646 sq. km of beaches, desert, highly arable land, vast grasslands, forests, mountains and, of course, the Great Rift Valley, which runs through the country from the North to the South.

Straddling the equator, Kenya enjoys a pleasant tropical climate and an abundance of both plant and animal life. The country's wide range of ecological zones facilitates the cultivation of a variety of crops and rearing of livestock. By and large, agriculture has been and remains the principal economic activity, accounting for about 24 per cent of Gross domestic product (GDP), although its importance has gradually declined from a high of about 40 per cent.<sup>1</sup> Although tea and coffee have for a long time been the key foreign exchange earners, horticulture is becoming increasingly important.

While its rapid growth has in the recent past been negatively impacted by persistent threats to world peace, tourism has in the last decade or so grown significantly in stature, quickly becoming the second most important industry in terms of its contribution to GDP at almost 20 per cent. The manufacturing sector has also experienced steady growth over the years and currently contributes about 13 per cent of GDP. Traditionally composed of large and medium-size enterprises, it has in the recent past seen the proliferation of small and micro enterprises, which are making a significant contribution particularly with regard to employment creation.

Kenya has fairly well developed infrastructure, including international and domestic air transport facilities, one of the most modern ports in Africa, an extensive road network with all-weather roads connecting major commercial centres, a railway system and a well-established communication system. Relative to other countries on the continent, it has fairly well developed financial and capital markets, with its stock market rated by the International Finance Corporation (IFC) the most promising emergent market in 1994. The media are liberalized and the quality of journalism is high. Its major cities are cosmopolitan, populated by people of all types of racial and cultural backgrounds. The Kenyan people themselves are relatively well educated, highly skilled and hardworking.

Since 1964, a year after its independence from Britain, Kenya has been a democratic republic led by a president who is directly elected by the people and in

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<sup>1</sup> Further details and statistics can be found at the Investment Promotion Centre website [www.ipkenya.org](http://www.ipkenya.org).

whom significant executive powers are vested. The Government as established under the independence constitution has three arms—the Executive, responsible for the day-to-day running of government; the Legislature, which is the law-making authority; and the Judiciary, responsible for the determination of disputes and dispensation of justice.<sup>2</sup> The constitution provides for the separation of powers between the three arms of government to ensure checks and balances and prevent the abuse of power. The effectiveness of this in practice has, however, been the subject of intense debate, culminating in the constitutional review process currently underway.

For the most part, Kenya has and continues to enjoy political stability. In 2002, there was a significant general election in which the Kenya African National Union (KANU), a party that had ruled the nation for the previous 39 years, handed over power to the National Rainbow Coalition (NARC), an opposition alliance. The peaceful transition was heralded the world over as a sign of the political maturity of the Kenyan people and an example to be emulated elsewhere. Kenya continues to excel in sports and contributes to conflict resolution and peace-keeping missions, which have further endeared the country to the rest of the world and made it a natural leader on the continent. The country continues to play a leading role in many regional and international initiatives, including the East African Community (EAC), the Common Market for Eastern and Southern Africa (Comesa), the African Union (AU), the African Caribbean and Pacific Group of States (ACP) and the United Nations—with the United Nations Environment Programme (UNEP) and United Nations Human Settlements Programme (UN-Habitat) headquarters in Nairobi along with the regional offices of other UN agencies.

All these factors have combined to make Kenya the economic hub of East Africa and a respected country within and beyond the continent. Economically, however, the country is yet to realize its potential. Kenya has pursued a mixed economy since its independence in 1963. In the decade immediately after independence, it enjoyed strong economic growth, averaging an annual growth rate of 6.5 per cent. Performance has since then, however, declined sharply, hitting an all time low of -0.2 per cent in 2000. All other economic indicators have shown a similar downward trend. This poor performance is largely attributed to poor governance and its attendant consequences, over-reliance on primary products and the sizable role played by the State in the economy, coupled with an increasingly competitive and demanding global market.

In a bid to address this sad state of affairs and improve performance, there has been a marked shift in emphasis from public investment to private-sector-led growth. The Government has in its development plans recognized the private sector as the wealth-creating organ of society. Consequently, it has initiated various reforms to restrict its active participation in economic activity and focus its resources on creating an environment within which enterprise can flourish. Such reforms include trade liberalization, review of the exchange rate policy, including the removal of price controls and repeal of the Exchange Control Act, and various financial sector reforms.

The need for reforms has not been felt by the Government alone. Chiefly owing to the concern over declining economic performance and the urgent need to remedy the situation, the corporate leadership recognized in the mid-1990s the urgent

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<sup>2</sup> The constitution is currently under review.

need for corporate governance reform to enhance economic performance. This pressure culminated in a workshop held in Mombasa in November 1998. The workshop brought together a wide array of stakeholders who recognized the urgent need for corporate governance reform. Consequently, it launched the Private Sector Initiative for Corporate Governance Trust to spearhead the promotion of good corporate governance in Kenya.

What began as a national private-sector-driven initiative has grown in leaps and bounds since its inception. While it was initially mandated to address issues of corporate governance in Kenya, the success of its programmes, particularly in training and research, has resulted in high demand from the rest of the region. During a regional meeting held in Johannesburg, South Africa, in 2001, its efforts were publicly acknowledged and it was appointed the Secretariat of the Pan African Consultative Forum on Corporate Governance, around which all other national initiatives on corporate governance are expected to coalesce. Now known as the Centre for Corporate Governance, its training programmes and the results of its research efforts are being replicated throughout Africa with much success. The choice of Kenya as the case study for Africa is therefore appropriate.

## **II. FRAMEWORK GOVERNING CORPORATE DISCLOSURE**

The corporate disclosure framework in Kenya comprises legal and regulatory requirements and voluntary initiatives.

### **A. Overview of the legal and regulatory framework**

#### **The Companies Act**

The principal legislation governing corporate disclosure is the Companies Act (Cap 486) of the Laws of Kenya, which is an act of Parliament to amend and consolidate the law relating to the incorporation, regulation and winding up of companies and other associations and to make provisions for other matters relating thereto and connected therewith. It is the Act under which the bulk of companies in Kenya, both private and public, are incorporated or registered.<sup>3</sup> The Act is based on the United Kingdom's 1948. Companies Act. Only minor amendments have been made to it since it was imported into the country.

In terms of disclosure requirements, the Act addresses at considerable length the following issues:

- Disclosures to be made in a prospectus
- Annual returns
- Accounts and audit
- Disclosures on matters pertaining to directors
- Registers and inspections
- General meetings

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<sup>3</sup> Registration is a requirement for foreign companies operating in Kenya.

## **Relevant Acts of Parliament**

There are also organizations that are set up by specific Acts of Parliament. These are largely State-owned corporations, particularly those classified as “regulatory” or “strategic”.<sup>4</sup>

In terms of disclosure requirements, the acts largely mirror the provisions of the Companies Act, save that they contain provisions that entrench the control of the State. Such provisions pertain to the appointment of boards, reporting mechanisms and audit requirements. For these corporations, audits can only be conducted by the Controller and Auditor General, who report to parliamentary committees on public accounts and investment.

## **The State Corporations Act<sup>5</sup>**

As in many other African economies, State-owned corporations play a significant role in Kenya. Owing to the plethora of State corporations subject to different legislative regimes, the State Corporations Act was enacted to streamline the operations of State corporations. For this reason, it is a statute of general application and specifically provides that in the event of conflict between its provisions and those of other statutes, including the Companies Act under which some state corporations are enacted, the State Corporations Act prevails.

In terms of disclosure requirements, the provisions of the State Corporations Act do not differ materially from those of the Companies Act. However, the statute confers significant powers on the Executive and particularly the President, the Responsible Minister, the Treasury and the Permanent Secretary of the parent ministry, who is the accounting officer.

## **The Cooperatives Act<sup>6</sup>**

The Cooperative movement in Kenya is a key player in the economy, contributing about 40 per cent of GDP. Cooperatives are incorporated and regulated by the provisions of the Cooperatives Act.

The Act addresses among other issues:

- Registration and dissolution of cooperative societies
- Rights and liabilities of the societies and members
- Management
- Amalgamation and division of societies
- Property and funds (management of)
- Settlement of disputes

The act has recently been revised with the express purpose of reducing the role of government in the management of cooperatives, which has been cited as one of the major reasons for the collapse of many of the large cooperatives. The new act, which

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<sup>4</sup> These are largely corporations whose primary objective is not commercial but have a wider national interest or impact e.g.

<sup>5</sup> Cap 446 of the Laws of Kenya.

<sup>6</sup> Act no. 12 of 1997.

does not effectively address issues of governance and disclosure, has come under intense criticism and another review is already in the offing.

## **B. Sectoral laws on banking and investment and other legislation**

Various legislative and regulatory requirements are scattered in other laws, including manufacturing laws, intellectual property laws, property laws, labour laws, tax laws and, particular, sectoral laws on banking and investment, including insurance, retirement benefits, capital markets and banking laws. Of particular interest in terms of corporate governance disclosure are the last four.

### **Insurance**

The insurance industry, which is still regulated by a department of government, has not made much progress in enhancing the legal and regulatory framework.

### **The Capital Markets Act and Regulations made by the Capital Markets Authority**

Capital markets bring together owners and users of capital and, in so doing, play an important role in mobilizing and allocating resources for development. Through various instruments, they provide a mechanism through which savings can be channelled into productive activities. Robust markets in particular play an important role not just in the allocation of capital but also in its optimization by ensuring that scarce resources go to the most effective users. They also separate ownership from control of resources, enabling entrepreneurs to finance their ventures in an effective and accountable manner to the benefit of the entrepreneur, the investor and society at large. By providing reasonable and reliable returns in an effective and transparent manner, capital markets provide an incentive for investment, thus promoting a culture of thrift and saving.

Capital markets in Kenya, though fairly well developed by African standards, are small and volatile. The diversity of products offered is limited. Trading volumes and liquidity are low. The technology employed in trading and settlement is archaic and unreliable. Rules are opaque, compliance is low and enforcement is weak.

For a long time, disclosure requirements were insufficient and there was inadequate protection of investors. At the same time, outdated laws and cumbersome licensing complicated entry, impeded efficient operation and discouraged orderly exit.

In 2002 the Capital Markets Authority, working with the Nairobi Stock Exchange, developed a new legal and regulatory framework that conforms to the best international practices.

Of the rules so developed, the key ones in ensuring corporate disclosure by listed companies include<sup>7</sup>:

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<sup>7</sup> The Capital Markets Authority developed and gazetted the following regulations and guidelines:

- Nairobi Stock Exchange Listing Manual;
- The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations 2002;
- The Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya.

The rules have greatly enhanced disclosure requirements for listed companies on both initial listing and continuing listing obligations. They have also improved timeliness, requiring quarterly reports as opposed to the previous half yearly ones. The level of disclosure has also been enhanced.

The Authority has also issued fairly comprehensive guidelines on corporate governance for listed companies, building on the code developed by the Centre for Corporate Governance. Appendix 1 contains a summary of the Capital Markets Corporate Governance Guidelines.

These enhancements have already made some quick gains, with many listed companies making changes to their governance practices. Of particular interest is the establishment of audit committees with independent, non-executive directors and corporate governance disclosure in annual reports.

### **Banking regulations**

Given the importance of the financial system in a country's economy and the problems that have plagued the financial industry in Kenya, it is not surprising that the Central Bank of Kenya has been at the forefront of improving corporate governance disclosure in banks and financial institutions. Through its Prudential Regulations and circulars, the Bank has greatly enhanced the depth of reporting by banks and financial institutions, particularly regarding bad loans portfolios and credit practices. Banks are required to publish detailed balance sheets and profit and loss statements as well as their lending rates in national newspapers. Timeliness has also been boosted, with the banks being required to submit audited reports within three months of the close of the financial year.

The Bank has also addressed the issue of audit committees, making them mandatory, and vets all director appointments.

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- The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations 2002;
  - The Capital Markets (Licensing Requirements) (General) Regulations 2002;
  - The Capital Markets (Takeovers and Mergers) Regulations 2002;
  - The Capital Markets (Foreign Investors) Regulations 2002;
  - The Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya<sup>7</sup>;
  - The Capital Markets Guidelines on the Approval and Registration of Credit Rating Agencies.

The Exchange reviewed its existing rules and regulations, including:

- Nairobi Stock Exchange Listing Manual;
- Trading & Settlement Rules;
- Management & Membership Rules.

## **The Retirement Benefits Act and Regulations issued by the Retirement Benefits Authority**

Although one of the youngest regulatory authorities in Kenya, the Retirement Benefits Authority has kicked off on a high note with simple but elaborate legislation touching on all critical areas of corporate governance practices, including disclosure for retirement benefits schemes. The Authority is also one of the more highly respected in terms of its ability to respond proactively, monitor, encourage and enforce compliance, and inject a level of professionalism into an industry with some of the poorest governance standards, which have resulted in unbridled plunder. This is particularly significant given the massive resources that retirement benefits schemes control.

### **C. Voluntary initiatives**

#### **The Nairobi Stock Exchange**

The Nairobi Stock Exchange was constituted as a voluntary association of stockbrokers and registered in 1954 as a society under the Societies Act.<sup>8</sup> In 1990, it was incorporated under the Companies Act as a company limited by guarantee and without a share capital. To date, it has 18 broker and three dealer members. There are 53 companies listed on the various tiers of its Official List, in addition to 18 month, 1, 2, 3, 4, 5, 6, 9 year, Government of Kenya treasury bonds, and in July 2003 a 10-year Government of Kenya treasury bond. As of 31 May 2003, total market capitalization (both equity and debt) was US\$4.44 billion,<sup>9</sup> constituting 33.57 per cent of GDP<sup>10</sup>.

Although like itself its members are licensed by the Capital Markets Authority and the listed companies are approved by the Capital Markets Authority, the Exchange is primarily responsible for regulating members and the conduct of listed companies through its various rules and regulations. Of particular importance is its role in monitoring and enforcing continuing listing obligations, which are geared to ensuring comprehensive and timely disclosure, particularly of material information pertaining to the performance of listed companies. This is geared to enhancing information symmetry and stemming market manipulation.

The Nairobi Stock Exchange Listing Manual and the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations 2002 requirements on corporate disclosures are similar, so as to ensure that there is no discrepancy between what the Exchange and the Authority require from issuers of listed securities.

While the Stock Exchange, working with the Capital Markets Authority, has contributed significantly to improving corporate governance disclosure amongst listed companies, its impact at the national level has not been significant owing to the small number of listed companies, most of which are foreign-owned and controlled. However, the Exchange has played a critical role in the development of capital markets and stock exchanges in Africa to facilitate and ease the flow of capital, an

<sup>8</sup> Cap 108 of the Laws of Kenya.

<sup>9</sup> US\$2.43 billion for equity and US\$2.02 billion for debt securities, using an exchange rate of US\$1: Ksh. 73.25, as per the 2003 annual report of the Nairobi Stock Exchange.

<sup>10</sup> Provisional (GDP market prices) for 2002 is quoted at Ksh. 969353.9 million on page 10, Republic of Kenya Economic Survey 2003.

important factor in enhancing corporate governance and disclosure. The Exchange is also in the process of automating its trading and settlement systems, which have hitherto been manual, to ease trading, shorten settlement cycles and significantly reduce systemic and operational risk.

### **Professional Associations**

Professional associations continue to play a critical role in enhancing corporate governance disclosure in Kenya. The Institute of Certified Public Accountants has been the main crusader for the adoption of international accounting and audit standards, which were adopted in Kenya with effect from January 1999. This has brought Kenyan reporting standards to world-class standards. This endeavour has been supported by regional organizations such as the Eastern, Central and Southern African Federation of Accountants and the Association of Certified Chartered Accountants.

Other professional associations that have in various ways contributed to enhanced corporate governance disclosure include:

- The Institute of Certified Public Secretaries of Kenya
- The Law Society of Kenya
- The Association of Kenya Stockbrokers
- The Association of Practitioners in Advertising

### **Trade and Business Associations**

Much like the professional associations, trade and business associations have played a significant role in improving corporate governance practices in general and responsibility and reporting in particular. Some of the key associations are:

- The Kenya Flower Council
- The Federation of Kenya Employers
- The Nairobi Central Business District Association
- The Association of Micro Finance Institutions
- The Kenya Institute of Bankers
- The Association of Kenya Insurers

### **Non-Governmental Organizations**

A number of non-governmental organizations such as Action Aid and Transparency International have also in the course of executing their mandates agitated for improved disclosure, particularly as it pertains to the impact of the activities of corporations on the environment and the communities in which they operate.

## The Centre for Corporate Governance

The Centre for Corporate Governance, which is the heart of the corporate governance initiative in Kenya, is private-sector-led. It is an initiative to improve the quality of life in Kenya and the African region by fostering the highest standards of corporate governance in all organizations. In this endeavour, it has adopted an all-inclusive approach, which demands that all stakeholders, including government, corporations, value-led organizations and society as a whole, effectively play their role.

Over the period from March to August 1999, the Centre, then called Private Sector Corporate Governance Trust, reviewed various codes of best practice developed internationally<sup>11</sup> and the circumstances prevailing in Kenya, and drafted a set of principles and a sample code of best practice for Kenya, which were circulated to the corporate sector and regulatory authorities.

Thereafter, the Centre made recommendations to a national seminar on corporate governance held on 8 October 1999, where it was resolved that the “Principles for Corporate Governance in Kenya and Sample Code of Best Practice” be adopted. These were published and distributed in November 1999. The principles and sample code incorporating international standards were deliberately drafted to excite and incite debate on good corporate governance in Kenya and facilitate local ownership of efforts to promote good governance.

At the national seminar, it was agreed that standard setting was the start of a process, the most difficult part of which was implementation. It was therefore agreed that the Centre would create the national capacity to implement those principles; install a culture of compliance; and create a suitable mechanism to recognize and reward good governance.<sup>12</sup>

<sup>11</sup> The international, regional and local codes and materials included the following:

- 1968 NCKK working party report on “Who Controls Industry in Kenya”
- The December 1992, UK, Cadbury Committee Report on Financial Aspects of Corporate Governance
- The November 1994 South Africa King Report on Corporate Governance
- The July 1995 UK – Sir Richard Greenbury Committee Report on Director’s Remuneration
- The January 1998, UK Hampel Committee Report on Corporate Governance
- The November 1998, Kenya Institute of Bankers’ “Code of Ethics”
- The February 1999, Draft OECD Principles of Corporate Governance for the Commonwealth.

<sup>12</sup> Specifically, the Centre was requested to:

- Build appropriate institutions with the requisite capacity to implement the principles and code of best practice
- Build national capacity to implement and apply the Principles of Corporate Governance through training, education, research, monitoring, evaluation, knowledge management and advocacy programmes.

To date, the Centre has achieved the following:

- The Principles and Sample Code of Best Practice for Corporate Governance in Kenya, Guidelines for Good Corporate Governance in State-owned-corporations and Corporate Governance Guidelines for Members (Shareholders) have been published and widely disseminated;
- Corporate governance has now been put on the Kenyan policy agenda, evidenced by the fact that:

#### **D. Principles of good corporate governance in Kenya and sample code of best practice**

The Kenyan Code, which is principles-based, encourages a “comply or explain” type of reporting. It supports the disclosure requirements that UNCTAD-ISAR identified at its nineteenth session as critical aspects of disclosure.

#### **E. Comparison of Kenyan practices with global best practice**

Various efforts to improve corporate governance practices in Kenya, including disclosure, are beginning to bear fruit. Much has been done to improve the legal and regulatory framework. The key regulators have recently reviewed and continue to improve their specific frameworks. The Capital Markets Authority, Central Bank and the Retirement Benefits Authority particularly stand out in this regard. The Companies Act, however, is still a serious bottleneck. It is terribly outdated and badly in need of reform. This is particularly serious as it is in many ways the foundation on which the other laws are built. Fortunately, the Government has recognized this. A task force was set up to study the act and make recommendations as to its review. The task force has completed its task and what remains is implementation of its recommendations.

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- The Central Bank of Kenya now demands good corporate governance for financial stability and sustainability from all licensed banks and financial institutions;
  - The Capital Markets Authority requires all listed companies to comply with principles of good corporate governance;
  - The Government has formally adopted the Principles of Good Corporate Governance in State-owned corporations, and the Inspectorate of State Corporations is now reviewing corporate governance in State-owned enterprises;
  - Universities are now examining their own governance practices;
  - Many public, private and State corporations boards are requesting seminars or training on corporate governance;
- 
- Collaborated with the African Capital Markets Forum, the United Nations Economic Commission for Africa, the Secretariat for Institutional Support for Economic Research in Africa and the CACG to organize the African Consultative Corporate Governance Forum in Johannesburg held from 16 to 18 July 2001 with the support of the GCGF, CIPE, the World Bank and the Commonwealth Secretariat, where it was requested to act as the Interim Secretariat for the Pan-African Initiative.
  - Has successfully conducted a variety of training courses throughout the region, including the CACG Five Day Certification Courses training about 1000 directors and 40 trainers in corporate governance.
  - Has developed postgraduate and diploma curricula and initiated discussions with local universities with the objective of facilitating introduction of diploma and graduate courses in corporate governance.
  - Facilitated the setting up of an Institute of Directors for the primary purpose of promoting director professionalism.
  - Facilitated the setting up of the Kenya Shareholders' Association to mobilize shareholders to effectively play their role in demanding and enforcing good governance.

The composition of boards and their performance are improving. Recruitment of non-executive directors is more rigorous. The areas of strategy and risk management, which have generally been ignored, are gaining more attention. Committees, and particularly audit committees, are a common feature. In the capital markets and the banking industry, they are a legal requirement. Stakeholders are being recognized and respected. Disclosure is improving. In the banking industry, it is fairly elaborate, public and timely. Listed companies are beginning to issue statements of corporate governance in their annual returns.

The voluntary code, on the other hand, developed by the Centre for Corporate Governance compares favourably with international standards and particularly with the disclosure requirements that UNCTAD-ISAR identified as outlined above, and has been hailed by the Commonwealth Association for Corporate Governance as an example to be emulated throughout the Commonwealth.

Enforcement remains the primary problem in Kenya. The capacity of regulators to enforce compliance with the law is terribly weak. They lack the resources both human and material to be effective and are largely perceived as ineffective. The Office of the Registrar General is particularly constrained and is unable to enforce many of the most basic requirements. The same applies to most professional, trade and business associations.

It is partly due to the recognition of the resource constraint that the Centre has chosen a principle-based approach and focused on creating credible leadership in corporations that is committed to, rather than forced to, comply with the principles of good corporate governance.

#### **F. The challenge of promoting good corporate governance practices in Kenya and the rest of Africa**

Africa, arguably the second most endowed continent in the world in terms of natural resources, is also ironically by far the poorest. For almost as long as history has been recorded, it has been mired in abject poverty.

Conflict is one of the principal reasons for Africa's misery. Conflict renders it impossible for economic actors to plan and undertake the activities necessary for the creation of wealth. Poor political governance and the subsequent concentration of political and economic power in the hands of a small, privileged and entrenched elite similarly continue to bedevil many countries on the continent.

Physical infrastructure, including transport and communication facilities, is either non-existent or decayed in most of the continent. Legal and regulatory systems are weak, and capital and financial markets are underdeveloped and in most countries non-existent. Social inequalities are prevalent. People are not meaningfully involved in the formulation and implementation of development plans.

To be successful, efforts to improve corporate governance (including disclosure) in Africa must be cognizant of these problems as well as other peculiarities of the continent. These include the great diversity of enterprises, the

complexity of the ownership structures, weak legal and regulatory systems, poor political and public governance where institutions are absent, underdeveloped and ineffective, small volatile and financial markets, and an unenlightened and dependent populace.

The issue of public governance, which has largely been weak — particularly public policy and national economic priorities — and the broader issues of the national ideological framework, values, justice systems, ethics and social infrastructure that underpin the business environment must be addressed. In spite of the poor public governance that characterizes the continent, experience has shown that the demonstrated willingness of the private sector to become competitive well governed and the efficient agent of growth compels the Government to play its role in improving and supporting the private sector. It is not an easy task, but the private sector can lead the way in introducing, facilitating and promoting good corporate governance practices even in an environment of non-supportive public governance.

The need for further legal, regulatory and policy reform is paramount. The capacity of regulatory authorities to enforce the law must be addressed. Many of the public scandals, grand theft and corruption cases reported in recent years have involved all types of enterprises, including transnational or offshore companies, and private and family companies established to use “the veil of incorporation” as a cover for fraud or to conceal the identity of the real owners, who have manipulated local directors and innocent shareholders in order to use those companies as conduits for fraud or market manipulation. Systems for monitoring and evaluating compliance with good corporate governance practices and strengthening the incentives for good corporate governance must be developed. To maximize effectiveness, they must be coupled with effective networks for research to document good practices and demonstrate their benefits to encourage their replication as well as identify bad practices and their effects so as to discourage them.

Self-regulation must also be strengthened. National capacity must be created to provide effective leadership to those entrusted with the governance of corporations. Many of the financial institutions, the huge public land buying companies and cooperative societies that have collapsed have done so because of improper governance and severe conflicts of interest. Efforts must be stepped up to enhance the capabilities of directors.

For the bulk of the people of Africa, the Government is not a facilitator but an active player in every facet of life, including business. This has had two major and unfortunate consequences. The first is the emergence of a culture of dependence by the citizenry. The second is an unhealthy preoccupation with political power where political power is synonymous with economic power and wealth. There is thus an urgent need to promote inclusive partnerships for sustainable wealth creation, which involve the public and private sectors and civil society, as well as to encourage greater public and community involvement in promoting, demanding and enforcing good corporate governance.

## **G. Conclusion: Lifting African standards to world-class standards**

Globalization means greater reliance on market forces and calls for highly effective corporations with world-class standards of governance. In his book *Corporate Governance: The New Paradigm*,<sup>13</sup> Gopalsamy accurately notes that more than ever before, to survive and thrive, corporations are required to gear up to exploit global market opportunities while defending and increasing their domestic shares in a liberalized and highly competitive global environment.

Unfortunately, Africa appears totally unprepared for this reality. As long ago as 1991, Duncan N. Ndegwa, then the Governor of the Central Bank of Kenya observed in a paper titled “Africa and the world: Africa on its own”<sup>14</sup> that Africa, and especially sub-Saharan Africa, continues to be marginalized economically – a development he described as negative, unfortunate and not in the interest of the international community. The consequence of this marginalization is deepening poverty in an already desperate continent and the serious threat that this poses to world peace and security.

Under the New Partnership for Africa’s Development (NEPAD) the political leadership of Africa has recognized the critical importance of good economic and corporate governance buttressed by effective peer review to economic development and prosperity. African Governments have in principle agreed to the following as key priority thrusts to address the challenges facing Africa:

- Restoration of peace, security and stability with consolidation of democratic gains and strengthening of democratic structures and institutions;
- Establishment and entrenchment of good economic and corporate governance;
- Bridging the infrastructure gap and creating social capacity for development;
- Human resource development and capacity building;
- Reduction of poverty and income inequalities through accelerated economic growth and sustainable wealth creation;
- Reconfiguration of global financial architecture with emphasis on investment promotion and redefinition of relationships with development partners focusing on debt reduction, increased aid and aid reform;
- Integration of the continent into the world economy and enhanced market access; and
- Preservation and conservation of the environment.

The same leadership through NEPAD has gone further to initiate preparatory actions that would: Facilitate negotiations with the developed world through a united African front;

- Highlight critical infrastructure projects;

<sup>13</sup> Gopalsamy, 2000, *Corporate Governance: The New Paradigm*, A H Wheeler Publishing Co Ltd.

<sup>14</sup> Africa: Rise to Challenge by Obasanjo and Masha, Africa Leadership Forum, New York, 1993.

- Create and enforce standards of political, economic and corporate governance;
- Declare the period 2002- 2012 the capacity-building decade for Africa;
- Rationalize the institutional framework for economic integration.

One of the key strategic thrusts of NEPAD is the improvement of economic and corporate governance. It is important to make the point that the Government alone cannot achieve this. It calls for the establishment of effective partnerships between the public sector, the private sector and civil society that will enhance the spirit of participatory development and increase citizen engagement in creating a secure and stable environment in which the private sector can grow and thrive. Determined efforts must be made to inculcate a culture of transparency and accountability. The community cannot be left behind, since much depends on the extent to which society is able to inculcate in, and demand of those in whom it vests power over its resources, a philosophy that regards the common good of society as the most critical success factor.

These are some of the concerns that emerged at the regional meeting held in July 2001 which resulted in the formation of the Pan African Consultative Forum on Corporate Governance with a mandate to *inter alia*;

- Coordinate corporate governance initiatives in Africa and facilitate agreement on minimum principles of best practice that are compatible with international standards;
- Support the establishment of national initiatives on corporate governance where they do not exist and help build capacity to implement good corporate governance practices;
- Facilitate the exchange of information and experiences and promote joint programmes and research, culminating in the optimal use of limited resources and establishment of an interactive Pan African Corporate Governance website.

The Forum, with its Secretariat at the Centre for Corporate Governance in Kenya, has been working together with various development partners and other regional initiatives, including NEPAD, to network, facilitate the exchange of information, and to jump-start and support country initiatives. In July this year, it will be holding the second regional meeting in Nairobi to consider the progress made since the last meeting and to chart the way forward.

Much has been achieved, but more remains to be done for Africa to rise to the challenge posed by Dr. K. Kaunda, former president of Zambia, when he said that “The ability of the leaders of Africa to lead the people of Africa into the exploitation of the resource of their continent to the greatest advantage of the people of Africa is the greatest challenge to us the people of Africa today and tomorrow. It is this which

will decide the difference between the Africa of yesterday and today, on one side, and the Africa of tomorrow and the future ahead, on the other side”.<sup>15</sup>

**Appendix 1. Summary of the capital markets authority's corporate governance guidelines**

No.	Items	Corporate Governance Guidelines (Ref.)
1	<b>General:</b> A statement by the directors as to whether the company is complying with the guidelines on corporate governance.	1.8
2	<b>General:</b> Where the company is not fully compliant with the guidelines on corporate governance, the reasons for non-compliance are to be stated and steps are to be taken to be compliant.	1.10
3	<b>Board and Board Committees:</b> Disclosure of the establishment of relevant committees	2.1.1 (i)
4	<b>Board and Board Committees:</b> Establishment of an audit and nominating committee	2.1.1 (ii)
5	<b>Supply and disclosure of information:</b> Disclosure of policies for remuneration and incentives for the Board and senior management, and particularly the following:  (a) Quantum and component of remuneration for directors, including non-executive directors, on a consolidated basis in the following categories: (i) executive directors' fees; (ii) executive directors' emoluments; (iii) non-executive directors' fees; (iv) non-executive directors' emoluments;  (b) A list of ten major shareholders of the company; (c) Share options and other forms of executive compensation that have to be made or have been made during the course of the financial year and (d) Aggregate directors' loans	2.1.3
6	<b>Re-election of directors:</b> Disclosure of all directors approaching their 70 <sup>th</sup> birthday in the respective year.	2.1.7
7	<b>Resignation of directors:</b> Disclosure of a resignation of a serving director together with the details of the circumstances necessitating the resignation.	2.1.8
8	<b>Annual General Meetings:</b> Disclosure to all shareholders of sufficient and timely information concerning the date, location and agenda of the general meeting as well as full and timely information regarding issues to be decided during the general meeting	2.3.2
9	<b>A balanced board constitutes an effective board:</b> Disclosure as to whether independent and non-executive directors constitute one third of the board and if it satisfies the representation of the minority shareholders.	2.1.4 and 3.1.2

<sup>15</sup> Statement by Dr. Kenneth Kaunda, then President of Zambia, at the Africa Leadership Forum, Kampala, Uganda, 19 May 1991. See Africa Obasanjo and Mosha, 1993.



# **CHAPTER V**

## **CASE STUDY ON CORPORATE GOVERNANCE DISCLOSURES IN THE RUSSIAN FEDERATION**

### **I. INTRODUCTION**

The emergence of corporate governance in the Russian Federation took place within the context of Russia's transition to a market economy. Today the country has a new set of institutions and a functioning capital market that were scarcely imaginable in the not too distant past.

The challenges encountered during the transition can hardly be overstated. The Russian Federation's securities markets emerged at a time of strong economic contraction and profound societal change when markets were viewed with deep suspicion and skilled technocrats with market experience were non-existent. The Russian Federation was unique among transition economies, not only for the size of the transfer of State property to private owners and its speed, but also for the untamed nature of its privatization. Companies were privatized into the most rudimentary of share markets that lacked functional oversight and regulation.

The legal and regulatory frameworks are now largely in place. The revised Joint Stock Company Law (JSC Law) and the rules and regulations of the Russian Federal Commission on the Securities Markets (FCSM) determine the essentials of governance and disclosure. Progress has been no less dramatic in the governance of Russian corporations. Companies are increasingly attuned to shareholder needs, and financial intermediaries now have obligations under law to provide relevant information to investors. Stock exchanges are introducing more listing requirements and an active business press digs for stories. Altogether, a much improved disclosure framework should in the future provide for most necessary information.

The importance of corporate governance is now broadly recognized and there are efforts everywhere to improve it. The regulatory authorities and a small number of companies have been in the forefront of the drive to improve corporate governance practices. The Russian Federation has its own governance code, and market participants are becoming better at assessing the quality of governance and taking action. A growing number of Russian companies, whose controlling shareholders and executives see opportunities in the growth of the financial markets, have put governance on their reform agendas. And the benefits to companies are increasingly visible in terms of recognition and treatment by investors. Yet the number of such companies remains limited<sup>1</sup> and considerable challenges remain.

The Russian Federation's corporate governance problems can be traced back to its privatization programme that made insider dominance the most prominent feature of its enterprises. Mass privatization took the form of voucher distribution to the

population with special advantages for employees of enterprises and corporate insiders.

A process of consolidation of control began at the very earliest stage of privatization. The result was that immediately afterwards some 60-65 per cent of company shares were held by insiders, 20 per cent by outsiders and 15-20 per cent by the Government on average.<sup>2</sup> The consolidation of ownership and control was characterized by extensive abuse of minority shareholders.

Today, employees are no longer significant shareholders, having disposed of vouchers and shares early in the privatization process. The role of the State has also decreased while the role of managers and large outside shareholders has increased significantly.

The financial crisis of 1998 sparked an interest in governance issues that had been largely ignored during privatization and during the rapid development of the stock market, which has been growing since 2000 when the macroeconomic outlook for the Russian Federation had improved significantly, industrial production was on the rise, political stability had asserted itself and government authority was strengthened. Generally pushed by a concern to attract foreign investors and nudged by the regulatory authorities, a number of companies developed codes of corporate behaviour and began to adopt improved governance policies.

Some optimism is warranted in the face of the country's difficult market history, but optimism should be guarded. While improvement is visible everywhere, it is recognized that further work on corporate governance is needed, including strengthening the regulatory framework for protection of shareholder rights and enforcement mechanisms, as well as improvement of transparency. Enforcement in particular requires attention, as does the ability to seek recourse for violations and to actually win remedies from the courts.

The body of this text covers recent developments both in the public and private sectors and ends with some questions on implementation. The appendix includes a comparison of Russian governance disclosure requirements to the ISAR Transparency and Disclosure Requirements for Corporate Governance. Further details are furnished where available and references are included to lead the reader back to original sources.

#### **A. The public sector**

Corporate governance is determined by a set of laws, including the Civil Code, the Joint Stock Company Law, the Law on Securities Markets, the Law on the Protection of the Rights and Legal Interests of Investors on the Securities Market, the Law on Insolvency (Bankruptcy), the Administrative Procedural Code and the Corporate Governance Code, as well as other regulatory acts by the Federal Commission on Securities Markets (FCSM) and other agencies. Disclosure of governance-related information is required primarily by the Russian Joint Stock Company Law (JSC Law) and regulations issued by the Ministry of Finance and the FCSM (specifically the 1999 Law on the Protection of the Rights and Legal Interests of Investors on the Securities Market).

## The Joint Stock Company Law

The Joint Stock Company Law defines principal shareholder rights and corporate responsibilities. It was completed in December 1995, and a new amended version came into effect on 1 January 2001. The new law provides for better accountability, and for better protection of minority investors.<sup>3</sup> A summary of its key disclosure requirements follows:

- *General disclosure requirements*<sup>4</sup>: Under article 89 of the JSC Law, shareholders have the right to obtain copies of financial statements, accounting records, internal documents of the company approved by the shareholder general meetings and other governance bodies; documents on the status of branches and offices; the prospectus; minutes of shareholder, board of directors<sup>5</sup> and “revision commission”<sup>6</sup> meetings; a list of affiliated parties; the opinions of the revision commission, external auditor and government control agencies; a list of persons who have the right to take part in general meetings; the reports of independent appraisers; and other documents containing information which the company must disclose under the JSC Law or under other laws or regulations. Shareholders have the right to obtain copies of annual reports under FCSM regulations as well.
- Under article 91 of the JSC Law, shareholders who have no less than 25 per cent of voting shares have the right to obtain copies of bookkeeping records and the minutes of meetings of the management board.<sup>7</sup> Companies may charge shareholders for information, although fees may not exceed copying and mailing costs.
- *Related party transactions*: Members of the board of directors who are also part of management must disclose when they: (a) are parties to a transaction by the company; (b) hold at least 20 per cent of the voting shares of a legal entity that is party to a transaction; or (c) hold office in the management of an entity which is party to a transaction. Individuals must disclose their relationship to the board of directors, the revision commission and the external auditor. There is no requirement to disclose to shareholders.
- *Affiliated persons*: Under FCSM Resolution # 03-19/ps of 1 April 2003, all open joint stock companies are required to disclose information about their affiliates by submitting a list to a registrar within 45 days after the close of the quarter. Changes in the list of affiliates must be posted on the Internet within three days after the date when the company learned, or should have learned, about these changes. A letter must be submitted to the shareholder registry within three days after the date when the list is posted on the Internet to confirm that the list has been posted. If the website address is changed, and if access to the website is unavailable and later restored, the company must inform the registrar within three days of such an event.
- *Requirements for audit and compliance with legislation*: Joint stock companies must have their annual financial statements audited. The auditor must be approved at the annual general meeting, as must the amount of fees. Auditors also verify compliance of companies with Russian law. Either the auditor or the “revision commission” must prepare a report confirming the accuracy of the financial statements and report on violations

of procedures in preparing financial statements and/or violations of law or regulations.

- *Remuneration of board members and top executives:* Aggregate remuneration for the board and management board must be disclosed.
- *General Meetings (GMs):* Under the JSC Law, notification must be made 20 days before the GM, and 30 days before the GM, if the agenda covers the company's reorganization. Under the JSC Law and FCSM regulations, information that must be presented to a shareholder before the general meeting includes: (a) annual financial statements, in particular the auditor's report and the revision commission's report on the verification of annual financial statements; (b) information on the nominees to the company's management board, board of directors, revision commission and vote counting commission; (c) draft amendments to the charter of the company or a new version of the charter of the company; (d) draft internal documents of the company; (e) draft decisions of the general meeting of shareholders; (f) the annual report; and (g) information stipulated by the charter of the company and the JSC Law.

### **The Law on the Protection of the Rights and Legal Interests of Investors on the Securities Market**

The 1999 law imposes penalties for violations of information disclosure. The law was perceived as a watershed in Russian disclosure; as a result of its passage, filings with the FCSM increased by a factor of over 100.<sup>8</sup> Some of its specific requirements are:

- *Disclosure of significant ownership:* Investors must disclose to the FCSM when they have: (a) 20 per cent or more of an issuer's securities; or (b) increased or reduced their share of any issuer's securities by a multiple of 5 per cent in excess of 20 per cent.
- *Shareholder lists:* Lists must be provided to shareholders who own 1 per cent or more of the company's voting shares. Lists must include the names of the registered owners and the number, category and nominal value of their shares.
- *Quarterly statements:* Issuers must publish quarterly statements within 30 days of the end of the quarter. Statements must include: (a) a balance-sheet, a profit and loss statement, and a statement of sources and uses of funds; and (b) a discussion of factors causing changes in profits of more than 20 per cent compared with the previous quarter.
- *Controlling shareholders:* Quarterly reports are required on: (a) the members of the management bodies; (b) changes in the management bodies if members own more than 20 percent of the company's capital; and (c) changes in the list of companies in which the issuer owns 20 per cent or more of the authorized capital.
- *Material changes in financial position:* Issuers must advise the FCSM of material changes within five days of an event. Disclosure could be triggered by: (a) factors causing a change in assets or net profit of more than 10 per cent; (b) transactions involving 10 per cent or more of company

assets; (c) material changes in the information disclosed as part of the securities issue, and; (d) shareholders acquiring more than 25 per cent of the issuer's securities.

- *Prospectuses*: Prospectuses must include: (a) the structure of the issuer's governing bodies, including a list of members of the board of directors; (b) a list of companies in which the issuer holds more than 5 per cent of the authorized capital; (c) the issuer's balance sheet, profit and loss statement, and report on sources and uses of funds; (d) information on the issuer's authorized capital; and (e) information on prior securities issues<sup>9</sup>.

### **The Code on Administrative Offences**

The revised Code of Administrative Offences replaces penalties previously found in the Law on the Protection of the Rights and Legal Interests of Investors on the Securities Market. The code deals with violations of disclosure requirements. Effective since July 2002, it provides for fines of up to 150,000 Rubles or approximately US\$5,000 for violations of securities law. At this level, fines are clearly insufficient to encourage compliance with securities legislation, although individuals may be held liable for penalties imposed against a legal entity. The FCSM may file claims with the Russian Arbitration Court for violations of securities legislation and for the application of fines and sanctions. It is, however, restricted to filing lawsuits on its own behalf and not that of shareholders.

### **The Criminal Code**

Amendments to the Criminal Code (article 185, points 1 and 2) provide for penalties for knowingly: (a) giving false information in the prospectus; (b) approving a prospectus containing false information; (c) approving a report on the issue of securities and placement of securities (where the issue has not been registered by the State); (d) evading disclosure requirements by a person who must submit information to an investor or oversight body; and (e) disclosing incomplete or false information.

The following penalties may be incurred if the offence causes damages:

- A fine of 500 to 700 minimum wages
- A fine in an amount of the convicted person's wage or any other income for 5-7 months
- Mandatory labour for a period of 180-240 hours
- Corrective labour for 1 to 2 years.

Repeat offences are punishable by confinement of up to three years.

### **Russian Federal Commission on Securities Markets (FCSM)**

The FCSM is a relatively new agency, having been established in 1996. It develops laws and regulations designed to improve governance practices and ensure better investor protection, although it has some weaknesses that prevent it from functioning like a classic securities markets regulator. It is not fully independent and its chairman holds the position of minister in the Federal Government. In addition, the FCSM lacks sufficient statutory authority over stock exchanges to ensure adequate regulation. Its statutory authority to investigate securities violations is limited, as seen by a recent court order to halt an examination of RAO UES (Russian joint stock

power and electrification company). The FCSM's powers to sanction are also limited. Finally, the issue of a stable source of financing has not yet been resolved.

### **FCSM By-laws on General Meetings**

The by-laws of the FCSM mandate that joint stock companies provide the following additional information to shareholders while preparing General Meetings:

- Annual report;
- Report of the revision commission;
- Recommendation of the board of directors on disposal of profits, including payment of dividends.

The by-laws also mandate that the annual report shall contain the following information:

- Company's position in the industry in which it operates;
- Priority activities;
- Board of directors' report on priority activities;
- Company development prospects;
- Payment of dividends;
- Description of main risk factors;
- List of major transactions with details on each transaction;
- List of transactions with related (interested) parties, with details of each transaction;
- List of board members with their holdings of company stocks;
- Biography of CEO and members of the management board;
- Criteria for determining compensation of executives and board members;
- Level of compliance with the FCSM Code of Corporate Governance recommendations.

### **FCSM Code of Corporate Governance**

The FCSM has developed a code on corporate governance. In order to do so it set up a Coordination Council on corporate governance that included representatives from companies, investors, business associations, securities market participants and governance experts. The Code, officially presented in April 2002, includes recommendations on all key aspects of corporate governance practices, including disclosure, but also devotes considerable attention to access to data. Furthermore, it proposes going beyond the requirements of current legislation. Although it provides some detailed recommendations, it takes a principle-based approach that leaves the specific required disclosures open-ended. It also provides useful explanatory text that outlines the reasoning behind its recommendations. The Code benefited from input from the OECD, the World Bank and other international organizations, and was completed in late 2001.<sup>10</sup>

Chapter 7 of the Code is specifically dedicated to disclosure and is focused on the following main issues:

*Section 1.1: Company information policy should guarantee unhindered and low-cost access to information about the company.* This section assigns the responsibility for disclosure policy to the board of directors, requires the company to have a written disclosure policy approved by the board of directors, and encourages broad dissemination via the press and the Internet.

*Section 2.1: Prospectuses should include all significant information about the company.* This clause recommends exceeding disclosure on the board and other governance bodies required by law. It underscores the importance of supervisory and management board disclosure, the executive structure of the company and dividend policies, and seeks to improve disclosure on control and related party transactions. Suggestions are made for a more detailed breakdown of financial statements and better analysis of performance than required by law, including a discussion of prospective performance.

*Section 2.2: Quarterly reports for the fourth quarter should disclose additional information.* This provision suggests expanding information required by law for the fourth quarter to the entire year.

*Section 2.3: Companies should promptly disclose information about all factors that may be material for shareholders and investors.* This section suggests open-ended disclosures of any material events or facts beyond statutory requirements such as decisions on: increasing (decreasing) the charter capital; acquisition by the company of its own shares; a change in the company's priority areas of operation; amendments to the company's charter concerning issuance of preferred stock of a category different from the category of shares issued previously; and a change in the company's auditor, registrar or depository.

*Section 3.1 Companies should seek additional ways of furnishing information to shareholders.* This clause appears to set the overall spirit and tone of disclosure efforts.

*3.2 The Company Secretary should provide shareholders with access to information about the company.* This clause sets out responsibilities for providing information to shareholders.

*Section 3.3 During preparations for a general meeting of shareholders and in the course of such meetings, shareholders should be provided with exhaustive information on each item of the agenda.* Beyond standard items such as annual statements, this section sets out information requirements in cases of fundamental reorganization of the company or significant sales of company assets. Its provisions seem to be designed to combat asset-stripping transactions.

*Section 3.4 The annual report for shareholders of the company should contain necessary information that would enable shareholders to evaluate the results of the company's operations for the year.* This clause requires certification of the annual report by the chief executive.

*Section 4.1 Information that constitutes trade or professional secrets should be protected.* This section recognizes that some information may be withheld from the public and suggests the definition of criteria for withholding information by the board.

The FCSM Code is not legally binding. In April 2002, the FCSM adopted a by-law which recommends that companies disclose in their fourth quarter and annual reports the extent to which their practices comply with the Code's recommendations

and explain deviations from the Code's recommendations. The Code provides an important signal to the markets and some of its elements appear to be destined to find their way into legislation.

### **Accounting and Audit**

Requirements for accounting in the Russian Federation<sup>11</sup> are based on a number of different laws and codes, including the Law on Accounting, the Civil Code, accounting standards of the Ministry of Finance and other laws.

Russian authorities attach great importance to reforming Russian accounting towards International Financial Reporting Standards as the Government recognizes the benefits of adhering to a recognized international standard and has developed plans to converge Russian Accounting Standards (RAS) with IFRS.<sup>12</sup> It has announced that starting from 2004 Russian listed companies will prepare their consolidated accounts in accordance with the IFRS. However, RAS still differ from IFRS and more work is needed. The most significant differences were outlined in a survey conducted by the Big 5 accounting firms, *GAAP 2001, A Survey of National Accounting Rules Benchmarked Against International Accounting Standards*. This survey groups differences between RAS and IFRS into four major categories where (a) rules comparable to IFRS are absent; (b) specific rules requiring disclosure are absent; (c) inconsistencies between rules could lead to differences with IFRS; and (d) other issues that could lead to differences from IFRS. Some of the differences in the first category (the area that could result in the greatest differences in financial statements) relate to: business combinations; consolidation of Special Purpose Entities (SPEs); inflation accounting; impairment of assets; accounting for pension plans and employee benefits; and financial instruments among others.<sup>13</sup> Since then more work has been done and new standards have been issued in such areas as discontinued operations, research and development costs, income tax and financial investments. However, compliance with IFRS in these and other areas, especially at the level of practical implementation, is still to be achieved.

In a reforming process Russia has expressed a number of concerns about convergence, including: (a) the complicated nature of IFRS; (b) disagreement with certain significant IFRS; (c) a limited capital market that may not make IFRS (which are designed for markets) practical; and (d) difficulties in accurately translating IFRS into Russian.<sup>14</sup> One of the major concerns is that the Russian Federation still does not have an official Russian translation of IFRS. Another acute practical issue related to the implementation of IFRS is a need to develop a link between financial accounting and tax legislation which requires a coordinating effort involving the bodies responsible for tax and accounting.

In the interim, companies accessing the international capital markets already prepare their financial statements in accordance with IFRS or US Generally Accepted Accounting Principles (US GAAP). Over 50 per cent of the companies currently listed on the Russian Trading System (RTS) prepare their statements in accordance with IFRS or US GAAP. The Russian business community has been pressing the Government to accelerate the transition to IFRS and relieve companies that have already introduced IFRS or US GAAP of their dual record-keeping burden.

Russian audit standards are considered similar to the International Standards for Audit (ISA) as set by the International Federation of Accountants (IFAC). However, more effort is needed to ensure that Russian audit regulation and practices are in compliance with best international requirements. Many large companies still rely primarily on international firms for public audit services, especially when required for the purpose of international financing.

Further education and training both in international accounting and in international audit are vital. This is required for university students and for practising accountants.

## **B. The private sector**

### **Stock Exchanges**

The Moscow Interbank Currency Exchange (MICEX)<sup>15</sup> and the Russian Trade System (RTS)<sup>16</sup> dominate trading in the Russian Federation, although there are nine other exchanges. At the end of 2000, market capitalization on MICEX was \$60 billion, most of which was in corporate fixed-income securities. Four companies<sup>17</sup> represented some 90 per cent of trading volume, with one (RAO UES) representing one half. MICEX views transparency as fundamental to the functioning of its market and has sought to introduce better standards of disclosure into its listing requirements.

Trading on the RTS is more diversified than on the MICEX. However, even for RTS, 85 per cent of volume comes from just seven companies<sup>18</sup> that have a 25 per cent free float. For most companies, the percentage of shares not held by controlling shareholders or company managers is well below 15 per cent. RTS lists companies according to tiers that are determined by governance and disclosure standards. The highest-level tier must file statements prepared under US GAAP or IFRS.

New rules that became effective in early 2003 set the following additional requirements for listing on the RTS and MICEX A-Level quotation (the highest level):

- The issuer must provide the issue organizer with the following: material facts that affect the issuer's financial and business operations; the number of the issuer's shareholders; quarterly reports in compliance with the requirements as to the content and deadlines of producing this information as set by the FCSM regulations, and disclose information no later than five days after the date when the issuer learned or could have learned that one person and/or his affiliates had become the owners of more than 75 per cent of its common stock.
- One person and/or his affiliates may own no more than 75 per cent of the issuer's common shares.
- The issuer must breakeven during two out of three years preceding listing.
- The issuers must have a financial history of at least three years.
- An A1-Level listing requires compliance with the FCSM Code of Corporate Conduct, and the submission of supporting documentation to the exchange.

- An A2-Level listing requires compliance with the disclosure requirements in Chapter 7 of the FCSM Code of Corporate Conduct and submission of supporting documentation.

### **Corporate governance ratings**

Some conclusions on corporate disclosure in Russian companies could be drawn from surveys conducted by rating agencies and other organizations. Although not quite comparable owing to different methodologies used and also limited by nature as they have to be viewed within the context of economic performance, they still provide some insight into the state of affairs on corporate governance disclosure in Russia.

A number of organizations rate the governance practices of companies traded on Russian exchanges. The Investor Protection Association (IPA) and the Institute of Corporate Law and Governance (ICLG) have both published ratings. Brunswick UBS Warburg has conducted governance surveys with a component devoted to transparency. Standard & Poor's has established a corporate governance scoring service that covers 98 per cent of Russia's market capitalization and recently published a study devoted exclusively to transparency and disclosure in the largest Russian companies.

In December 2002 the Investor Protection Association (IPA) announced the results of the programme *Russian Leaders in Corporate Governance 2002*, which evaluates the quality of governance among leading Russian companies. The IPA is a non-commercial organization established in April 2000 for the protection of investor rights and the improvement of corporate governance in Russia. Assessments were conducted by IPA members comprising Russian and foreign companies with a total of over US\$10 billion invested in the Russian market. IPA members nominated *Vimpelcom*, *YUKOS*, *Sibneft* and *Norilsky Nickel* for best-governed company. *Vimpelcom* eventually won. *Norilsky Nickel* won the nomination for the company with the largest improvements in 2002.

The ICLG singles out *RAO UES* and *Sibneft* as companies that had improved their governance significantly. The ICLG ascribes *RAO UES's* high rating to its adoption of a Corporate Governance Code and other factors, including enhanced monitoring by the Board of Directors and improved disclosure. *Sibneft* was highlighted because of its decision to cancel treasury shares (that could potentially be used to dilute existing shareholders) and the addition of an independent member of the Board of Directors.

Despite the improvements at *Sibneft*, the ownership structure remains unclear and ICLG warned against continued potential for shareholder manipulation. This prediction came true a number of months after the survey when *Sibneft* first bought, and then sold back, a 27 per cent stake in the company to the same shareholder under obscure conditions. *RAO UES* was also criticized for a restructuring that resulted in the expropriation of minority shareholders.

Standard & Poor's Ratings Services publishes a transparency and disclosure study that includes the 42 largest companies in the Russian Federation.<sup>19</sup> Only the

shares of the 10 largest companies are liquid and most of the companies in the index have very concentrated ownership; one or more connected shareholders control more than 50 per cent. According to S&P, concentrated ownership appears to be related to lower levels of transparency in Russian companies.

The survey highlights the large spectrum of disclosure found among Russian companies. The top two companies in the study, *Mobile Telesystems* (MTS) and *Wimm-Bill-Dann*, made more than 70 per cent of the desired disclosures, which is comparable with disclosure levels in many Western European companies. *YUKOS*, *Vimpelcom*, *Golden Telecom* and *Rostelecom* reported on approximately 50 per cent of the desired disclosures. The remaining 36 companies exhibited significantly lower levels of disclosure, with the bottom of three companies making only 10 per cent of the needed disclosures. Of the largest 42 companies, 26 produce financial reports in accordance with internationally recognized standards.

In comparison to other regions of the world where S&P applies the same assessment methodology, disclosure among Russian companies is comparable with disclosure levels in Latin America, the global region with the lowest level of transparency. The survey reveals that the weakest aspect of Russian disclosure is executive remuneration. Lack of disclosure in this area as well as in the area of related parties, transactions and ownership structure downgraded S&P ratings of some Russian companies, which are well compared with best international practices in other respects. Further negative factors found in some companies are the absence of disclosure of the contractual relationship with the external auditor and the absence of an independent audit committee.

### **Company practices and initiatives**

Increasing numbers of companies have published corporate governance policies, including, most recently, *Gazprom* and *Rostelecom*; this makes about 20 companies in total. They are generally short and acknowledge the need for transparency, the need for independent audit committees and disclosure according to international standards. Governance statements of Russian companies are increasingly becoming available in the public domain.

In the second half of 2002 and the first half of 2003, some of the Russian Federation's largest companies started to disclose their ownership structure. *Yukos* and *LUKoil*, the largest and second largest Russian companies, and *AFK Systema*, a major diversified holding company, disclosed their beneficiary ownership structures and individual remuneration of their top managers. These steps were made in the wake of preparing for placing level 3 American Depository Receipts. In general large improvements in governance performance and transparency tend to come as a result of ADR's or direct listings on foreign exchanges. It is expected that other Russian companies will follow suit in the very near future.

Traditional views on the role and function of an audit committee have recently been challenged. Russian company law neither requires nor prohibits having a board audit committee. The law requires enterprises to have "revision commissions".<sup>20</sup> Yet a number of Russian companies, aspiring to attract foreign portfolio investors, have

voluntarily set up audit committees. For example, in *Yukos* and *United Heavy Machinery* independent expatriate directors head audit committees.

The mission and scope of revision commissions required by law are narrower than those of an audit committee. The revision commission focuses on monitoring compliance with law and regulation. It has the power to: (a) monitor compliance with regulations governing the economic activities of the company; (b) express an opinion as to whether reports and other financial statements of the company provide a true view and whether there are breaches of laws and regulations; (c) ascertain whether business and financial transactions are recorded properly; and (d) review controls. In practice, the members of commissions do not always have adequate training and the liberty to pursue investigations. The question arises as to which of these two structures (audit committee or revision commission) is better able to oversee the preparation of financial information and assess the systems of internal controls.

Many of the top-tier traded companies maintain websites that include reports on the company's financial and operating results. However, the websites of most traded companies are not updated regularly and it may be difficult to obtain copies of company reports from them or the FCSM. The FCSM may wish to consider improved access to company's financial statements on the Commission's public website.

One of most recent private sector initiatives is the establishment of the Russian Institute of Directors (RID). This is a not-for-profit organization established in November 2001 by a group of the largest Russian companies to: (a) promote improved corporate governance; (b) develop professional standards and rules of ethics for directors and company secretaries; (c) conduct research and training. It is also planning to launch a ratings system. The RID has also been active in a number of other areas. It has held a series of events dedicated to greater transparency and disclosure, including surveys and round tables. Its training programme for board members includes a special module on disclosure. The RID, in cooperation with foreign partners, published a manual for board members with an extensive chapter on disclosure.

### **The press**

In the Russian Federation, an important component of the corporate governance framework has been the press. In recent years, the Russian press has played an active role in strengthening the corporate governance framework by highlighting cases of abuses and by providing information and background to international correspondents. The Russian press has, for example, reported cases of asset stripping by company managers and shareholder meetings where minority shareholders are physically prevented from participating. Critics have pointed to the sensationalistic taste of Russian reporting. However, it seems that while the press may not always get the substance of matters right or be able to actually prevent abuses, it ensures that they remain in the public spotlight.

### **C. Implementation issues**

The basic institutional structures seem to be in place; the regulatory framework has improved significantly and a reasonable number of disclosures are required that, on a general level, compare with the requirements of countries with

larger and more developed securities markets. In practice, however, issuers disclose less information than required and users continue to voice concerns. In particular, they point to inadequate or distorted information with respect to ownership structures and the unreliability and inaccuracy in financial information,<sup>21</sup> and note the importance of successful legislation against offences related to non-disclosure or the provision of false information.<sup>22</sup>

For example, in spite of numerous requirements in law and regulations on disclosure of ownership, it is still difficult for shareholders and other stakeholders to obtain accurate information regarding the ultimate ownership and control of Russian enterprises.

More information should be disclosed about candidates proposed for board seats, their background and material interests in enterprises, the function of the board and its committees and board policies, internal control and risk oversight mechanisms. There is also a need to develop and implement performance evaluation in order to monitor the adherence of the board to accepted codes of governance.<sup>23</sup>

The majority of Russian enterprises do not disclose remuneration information nor do boards disclose remuneration policies. The absence of disclosure may illustrate the lack of sound internal rules for determining compensation. Companies will need to introduce more rational approaches to setting executive and director compensation and to the disclosure of their policies.

Much effort is needed to ensure the practical implementation of the IFRS and the development of the accounting and audit profession. Consideration should be given to the levels of training, testing and certification that are needed to implement new accounting/reporting requirements.

Consideration should also be given to strengthening the effectiveness of the FCSM in particular in ensuring that a stable and adequate level of financing for the FCSM is available and that imposed fines are sufficiently high to force compliance.

The current level of sanctions for non-compliance with the legislation and FCSM regulations is regarded as clearly insufficient.<sup>24</sup>

Access to information remains a concern. In particular, lack of information in English creates problems for foreign investors. Furthermore, disclosed enterprise information is not standardized, and this makes comparative analysis difficult.

There is a need to decide how to treat revision commissions and consider whether they can serve as audit committees. If one supports Western-style audit committees, amendments to the law would be required.<sup>25</sup>

There cannot be good governance or good transparency in the absence of educated executives and directors. More intensive training of executives and directors is needed since their understanding of governance is limited. Confusion seems to reign with respect to the difference between an outside director and an independent director, and the purpose of communications. Many boards are of the opinion that disclosure is not a part of their responsibilities.

## Appendices

<b>Comparison of Russian Practice to ISAR Transparency and Disclosure Requirements for Corporate Governance*</b>	
<b>Text of ISAR Requirements</b>	<b>Comparison to Russian Practice</b>
<b>I. Financial disclosure</b>	
1. <i>In particular, the group stressed the importance of disclosure of the company's financial and operating results, related-party transactions and critical accounting policies.</i>	Disclosure takes place under Russian accounting standards that differ significantly from IFRS and US GAAP and are of limited value to outside investors. Related-party transactions are poorly disclosed, if at all, and consolidated statements are generally not prepared.
2. <i>The group agreed that enterprises should disclose all the financial information necessary for shareholders and other stakeholders to properly understand the nature of their business and how it was being developed for the future. In particular, any accounting policies to which the published results of the enterprise are especially sensitive should be disclosed, and the impact of alternative accounting decisions discussed.</i>	While Russia has requirements for disclosures necessary to gain a full understanding of the company, compliance with law and regulation is low.
3. <i>The group recognized that enterprises should disclose all related-party transactions and in addition any related-party relationships where control exists. At a minimum, disclosure should be made of the nature, type and elements of the related-party transactions. Even related-party relationships where control exists, irrespective of whether there have been transactions with parties under common control, should be disclosed. The decision-making process for approving related-parties transactions should also be disclosed. Members of</i>	Beneficiary ownership is difficult to ascertain even when owners effectively control the enterprise. The definition of related parties is not clear in Russian law, and disclosure requirements are difficult to ascertain. The Joint Stock Company Law specifies the decision-making process for approving related-party transactions. Reporting depends largely on the good faith of related parties.  The FCSM Corporate Governance Code recommends that all related-party transactions be approved before the

\* The details contained in this comparative table were compiled by a consultant on a preliminary basis. They are also subject to change due to possible developments subsequent to the study.

<i>the board and managers should disclose any material interests in transactions or other matters affecting the company.</i>	transactions take place.
4. <i>Critical accounting policies that are key to the portrayal of an enterprise's financial condition and operating results should be disclosed.</i>	
<b>II. Non-Financial Disclosures</b>	
<b>A. Company Objectives</b>	
5. <i>The ad hoc consultative group agreed that the objectives of the enterprise should be disclosed.</i>	Requirements exist for disclosure of company objectives.
<b>B. Ownership and Shareholders' Rights</b>	
6. <i>The ad hoc group recognized that the ownership structure should be fully disclosed to all shareholders. It was also recognized that changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company became aware of them.</i>	Full disclosure of ownership structures is considered by outside analysts to be a significant issue for the great majority of companies. Requirements to disclose ownership can be found in various pieces of legislation. There are many cases of first-level disclosure of holding companies, and no information on beneficial owners. At present, the obligation to disclose rests with the company, though requirements may be more appropriately directed to shareholders.
7. <i>The group took the view that disclosure should be made of control structure and of how shareholders or other members of the organization can exercise their control rights through voting or other means. It also discussed that any arrangement under which some shareholders may have a degree of control disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed.</i>	Control structures are often obscure. Exactly how the enterprise is controlled in reality may not be apparent from filings. Shareholders' level of control over various governance processes is generally not clear.

<p>8. <i>The group agreed that rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.</i></p>	<p>Requirements for such disclosure exist. However, difficulties in ascertaining affiliates and beneficial owners may make implementation difficult.</p>
<p><b>C. Governance Structures and Policies</b></p>	
<p><b><i>The structure, role and functions of the board</i></b></p>	
<p>9. <i>The group took the view that the composition of the board should be disclosed, in particular the balance of executives and non-executive directors. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues are not significant and do not impinge on the independence of the directors.</i></p>	<p>In practice, board composition is not fully disclosed, nor is there generally any breakdown of executive and non-executive directors. Issues that may challenge director independence are not generally disclosed.</p> <p>The voluntary FCSM code calls for the following information on board members: age, education, positions held over the last five years, position held at the moment of nomination, nature of relations with the company, membership on the boards of directors or official positions held with other legal persons, official positions with other legal persons, information on relations with affiliated persons, the nature of relations with major business partners of the company, and other information related to financial status that may affect the discharge by the person of the duties of a member of the board of directors of the company.</p>
<p>10. <i>The group took the view that the board's role and functions must be fully disclosed.</i></p>	<p>Under the JSC Law, the role of the board of directors is clearly defined. Disclosure is often not observed.</p>
<p><b><i>Board committees</i></b></p>	
<p>11. <i>The ad hoc consultative group suggested that such governance structures be disclosed. In particular, the group agreed that the board should</i></p>	<p>Most boards do not have specialized committees, and little disclosure of this nature is made.</p>

<i>disclose structures put in place to prevent conflicts between the interests of the directors and management on the one side and those of shareholders and other stakeholders on the other.</i>	
<i>12. It was also agreed that the composition and functions of any such groups or committees should be fully disclosed. Where any director has taken on a specific role for the board or within one of these structures, this should be disclosed.</i>	The composition and function of committees is not generally disclosed. It is difficult to evaluate the roles of particular individuals within committees based on publicly available information.
<b>D. Members of the Board and Key Executives</b>	
<b>1. Duties and qualifications</b>	
<i>13. The group recommended that the duties of individual directors be disclosed. It was agreed that the number of directorships held by an individual director should be disclosed.</i>	The duties of directors and the number of directorships held are not generally disclosed.
<i>14. The experts took the view that there should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfill their responsibilities. There should also be disclosure of the mechanisms which are in place to act as “checks and balances” on key individuals in the enterprise.</i>	Biographical information is not generally disclosed, nor are specific “checks and balances”.
<i>15. There should be disclosure of the types of development and training that directors undergo at induction and on an ongoing basis (continuing education).</i>	Development and training of directors is never disclosed.
<i>16. Therefore, the group suggested that the board disclose facilities, which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the year in question.</i>	Advisory facilities for directors and their use are rarely disclosed.

<b>2. Evaluation mechanism</b>	
<i>17. The ad hoc group agreed that the board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the valuation are being used.</i>	Internal evaluation processes, where they exist, are never disclosed.
<b>Directors' remuneration</b>	
<i>18. The ad hoc consultative group took the view that directors should disclose a transparent and accountable mechanism for setting directors' remuneration. Disclosure should be as full as possible to demonstrate to shareholders and other stakeholders that pay is tied to the company's long-term performance as measured by recognized criteria. Information regarding pay packages should include salary, share options and other associated benefits, financial or otherwise, as well as reimbursed expenses. Where share options are used as incentives but are not treated as expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.</i>	Information on executive and director remuneration may be filed with the FCSM. This information is, however, very rarely disclosed.
<i>The group discussed that the length of directors' contracts as well as the nature of compensation payable to any director for cancellation of service contract should be disclosed. Specific reference could be made to any special arrangement that might relate to severance payments to directors in the event of a takeover.</i>	Director contracts and related information on remuneration are generally not disclosed.
<b>Succession planning</b>	
<i>19. The group took the view that the board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for sustaining the business. It also</i>	Succession planning is very rarely disclosed.

<i>recognized that there might be confidentiality issues and that the details of any individual plan should not necessarily be publicly disclosed.</i>	
<b>Conflict of interest</b>	
20. <i>The group suggested that conflicts of interests affecting members of the board should, if they were not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.</i>	Conflicts of interest are not generally disclosed.
<b>E. Material Issues Regarding Employees and Other Stakeholders</b>	
21. <i>The group recommended disclosure of whether there was a mechanism protecting the rights of other stakeholders in a business.</i>	The JSC Law requires that members of the board of directors perform their functions in the interest of the company, with no reference to stakeholders. Stakeholders generally have limited access to the same company information as shareholders – for example, access to information in the commercial court register and in the register of the FCSM.
<b>F. Environmental and Social Stewardship</b>	
22. <i>The group took the view that the board should disclose its policy and performance in connection with environmental and social responsibility and the impact of this policy and performance on the firm's sustainability.</i>	This type of disclosure could not be verified in the Russian Federation.
<b>G. Material Foreseeable Risk Factors</b>	
23. <i>The group took the view that the board should give appropriate disclosures and assurance regarding its risk management objectives, systems and activities. In particular, it was agreed that the board should disclose existing provisions for mitigating the possible negative effects of risk-bearing activities.</i>	In practice, risk analysis and risk oversight and management in company mechanisms to manage risks are never disclosed, though a discussion of risks is required during the annual general meeting. The absence of this type of disclosure is considered a crucial problem by outside analysts.

<i>The board should report on internal control systems and their effectiveness.</i>	
<b>H. Independence of Auditors</b>	
24. The group agreed that the board should disclose that it had confidence that the auditors are independent and their integrity had not been compromised in any way. The process for interaction with and appointment of internal and external auditors should be disclosed.	
<b>III. Annual General Meetings</b>	
25. <i>The group discussed the need for disclosure of the process for holding annual general meetings. Notification of the agenda should be made in a timely fashion, and the agenda should be made available in the national language (or one of the official languages) of the enterprise and, if appropriate, an internationally used business language.</i>	

**A Full List of Laws Determining Corporate Governance in the Russian Federation<sup>26</sup>**

- Civil Code of RF 51 from October 21, 1994
- Federal Law 208 “About Joint Stock Companies” from November 24, 1995
- Federal Law 39 “About the Securities Market” from March 20, 1996
- Federal Law 46 “About the protection of rights and legitimate interests of investors on the securities market” from February 12, 1999
- Federal Law 178 “About privatization of federal and municipal property” from November 30, 2001
- Federal Law 6 “About insolvency (bankruptcy)” from December 10, 1997
- Federal Law 74 “About particularities of disposition of shares of RAO ‘Unified Energy Systems’ and shares of other energy subsidiaries owned by the State” from June 20, 1997
- Law of the RSFSR 948-1 “About competition and restriction of monopolistic activity on commodities markets”
- Code of RF “About administrative violations” 195 from December 20, 2001
- Federal Law 23 “About changes and amendments to the Penal Code of the Russian Federation in the part of strengthening criminal liability for violations at the securities markets” from February 8, 2002.
- Decree of the President of RF “About measures aimed at protecting the rights of shareholders and the interests of the State as owner and shareholder”
- Regulation “About additional requirements to preparing, calling and holding general shareholders meetings”, approved by the FCSM Resolution 17/ps from May 31, 2002
- Regulation “About the procedures of holding absentee shareholders meeting”, approved by the FCSM Resolution 8 from April 20, 1998
- Regulation “About keeping the register of owners of registered securities”, approved by the FCSM Resolution 27 from October 2, 1997
- Resolution of the FCSM of Russia N 21 from August 30, 2001 “About recording shares not paid in full in shareholders’ registers and about making changes to the register keeping system, related to the transfer of shares back to issuers shall such shares not be fully paid within the legally required period of time”
- Regulation “About the procedure of money back (return of property) to securities owners, where such funds or property were received by the issuer as

payment for securities, in case, if such issue is declared invalid or ineffective”, approved by the FCSM resolution 36 from September 8, 1998

- Standards of securities issues during company start-up, additional placements, bonds and their Prospectuses, approved by the Resolution 19 from September 17, 1996
- Standards of bond issues and their prospectuses, approved by the FCSM Resolution 27 from October 19, 2001
- Standards of share and bond issues and their prospectuses during the reorganization of commercial entities, approved by the FCSM Resolution 8 from February 12, 1997
- Regulation “About the procedure of suspending the securities issue and declaring the issue invalid or ineffective”, approved by the FCSM Resolution 45 from December 31, 1997
- Order of the Ministry of Finance of Russia and the FCSM of Russia 71/149 from August 5, 1996 “About the procedure of appraisal of net assets of joint stock companies”
- Regulation about “The procedure of admitting securities, issued by companies registered in the Russian Federation, to initial public offering outside the Russian Federation for trading through foreign organized marketplaces”, approved by the FCSM Resolution 29 from November 23, 2001
- Resolution of the FCSM of Russia 7/ps from March 22, 2002 “About the procedure of admitting securities, issued by companies registered in the Russian Federation, to trading outside the Russian Federation, where such securities are not intended to be traded at organized markets”
- Regulation “About the securities issuer’s quarterly report”, approved by the FCSM Resolution 31 from August 11, 1998
- Resolution of the FCSM of Russia 2/ps “About the deadline for drafting and submitting the securities issuer’s quarterly report”
- Regulation “About the procedure of disclosing information about material facts (events or actions) related to the issuer's financial or business operations”, approved by the FCSM Resolution from August 12, 1998 32
- Resolution of the FCSM of Russia 28 from October 26, 2001 “About approval of the Regulation about the system of control over organized marketplaces and additional requirements to trade participants and securities issuers “
- Resolution of the FCSM of Russia 7 from September 30, 7 “About the procedure of keeping records about affiliated parties and disclosure of information thereabout”
- Regulation “About the procedure and volume of information disclosure by public joint stock companies during placement of shares and securities,

convertible into shares, through the subscription process”, approved by the FCSM Resolution 9 from April 20, 1998

- Federal Law 23-FZ “On an Amendment and Addition to Be Made to the Russian Criminal Code to Increase Criminal Liability for Crimes on the Securities Market”, as approved by the State Duma on February 8, 2002
- Letter of the FCSM of Russia IK-07/2861 from June 16, 2000 “About information contained in the voting ballot at the general shareholders meeting”
- Letter of the FCSM of Russia IK-07/883 from February 28, 2000 “About the period of authority of the Audit Commission”
- Letter of the FCSM of Russia IK-09/7948 from November 26, 2001 “About fractional shares”
- Letter of the FCSM of Russia IK-04/1608 from March 31, 2000 “About membership of legal entities in the Board of Directors”
- Letter of the FCSM of Russia IK-04/5159 from August 2, 2001 “About submitting notifications about acquisition of securities issued by companies registered in Russia, by foreign owners”
- Letter of the FCSM of Russia IK-04/3906 from August 4, 2000 “About submitting accounting statements together with the securities issuer’s quarterly report”
- Resolution of the Plenum of the Supreme Court of RF and the Plenum of the Supreme Arbitration Court of RF 4/8 from 02.04.97г. “About some aspects of application of the Federal Law ‘About joint stock companies’ ”
- Resolution of the Plenum of the Supreme Court of RF 12 from October 10, 2001 “About the question, arising from the application of the Federal Law ‘About Joint Stock Companies’ ”

**Documents to be made available to shareholder under the Joint Stock Company Law<sup>27</sup>**

- Founding documents
- Charter, Letter of Incorporation, Certificate of State registration
- Documents confirming the rights of the company to the assets on its balance sheet
- Internal documents
- The company branches' and Representative offices' Regulations
- Annual reports
- Bookkeeping documents
- Enterprise accounting
- Prospectus, quarterly reports and other documents
- Financial statements presented to regulatory authorities
- Minutes of the annual general meetings
- Minutes of meetings of the Board of Directors
- Minutes and reports of meetings of the Revision Commission
- Minutes of meetings of the company's executive body
- List of affiliated persons
- Auditor conclusions
- Conclusions of state and municipal bodies
- Voting ballots, as well as powers of attorney to participate in shareholders' meetings
- Reports of the independent auditor
- Lists of those possessing the right to participate in the general shareholders' meeting and other lists
- Other documents required by law

Only those shareholders holding in aggregate no less than 25% of the company's voting shares have access to the company's accounting documents and the minutes of the meetings. Documents are available for examination on the premises of the company's executive body within seven days from the date of request. If requested, the company is obliged to provide copies of documents. The amount of the fee for the provision of the documents may not exceed the expenses incurred in producing copies. Enterprise registers are held by various federal and regional registration bodies. Obtaining copies of company documents may in practice be difficult.

**Information to Be Disclosed in the Prospectus of Issuer under the Securities  
Market Law<sup>28</sup>**

1. Brief information about persons who serve in the company's governance bodies, information about bank accounts, auditor, appraiser, financial consultant and other signatories of the prospectus
2. Brief information about the volume, time lines, procedures and terms and conditions of issue placement
3. Main information about the company's financial and business situation and risk factors
4. Detailed information about the issuer
5. Information about financial and business operations
6. Detailed information about persons who serve in the company's governance bodies and bodies that oversee its financial and business operations; brief information about the company officers
7. Information about shareholders and interested-party transactions
8. Accounts and other financials
9. Detailed information about the procedures and terms and conditions of issue placement
10. Additional information about the issuer and its placed issues.

**Corporate Governance Charter of AO Yukos  
OAO NK YUKOS  
Resolution of the Board of Directors on Good Corporate Governance  
June 3, 2000**

**COMMITMENT TO INTERNATIONAL PRINCIPLES OF CORPORATE GOVERNANCE**

YUKOS has declared its allegiance to international principles of good corporate governance. The company's goal is to become a leader in Russia in this critically important area for industrial and overall integration into the world economy. The company Charter has been brought into full conformity with the Russian Joint Stock Company Law and, in order to eliminate dilution risk for shareholders, authorized but non-issued capital was cancelled. A new share issue will now require the approval of shareholders accounting for 75 percent of shares plus one share.

The new Board of Directors elected at the annual general shareholders meeting of June 3, 2000 retains only three members of current YUKOS management. Two-thirds of the Board is now composed of members of the international financial and oil industry community, leading Russian academics, and members of federal or local governmental institutions, bringing the widest range of professional experience to YUKOS.

At the first meeting of the new Board a "Corporate Governance Charter" was adopted, committing YUKOS to adhere to principles widely observed in member countries of the Organization of Economic Cooperation and Development.

The Board of Directors has reviewed various reports and proposals made in several OECD countries to improve corporate governance. It recognizes the benefit of good corporate governance to accelerate the development of the company through better management, greater availability and lower cost of capital.

The Board of Directors is committed to primarily creating the conditions to increase the value of Company's shares in accordance with the progress of the economic activity of the Company while taking into account the interests of the other stakeholders such as:

- Federal and local governments
- Employees and retirees
- Suppliers and lenders

In addition to the strict application of all laws and regulations applicable to the company and its governing bodies, and in order to enforce the above principles as soon as possible, the Board has decided the following:

- 1) It will create three internal committees: an executive committee as well as an audit and a corporate governance committee. The last two of these committees will be chaired by non-executive directors. The corporate governance committee will report to the annual shareholders meeting on the progress made by the company in this field. The current occupation and, where applicable, the link of all directors with the

company will be published in the annual report to the shareholders meeting.

2) The general organization of the management of the company will be made public and updated when applicable.

The Investors Relations officer position, which already exists, will be reporting directly to the CFO of the company. It is assigned the task of providing relevant, accurate and timely communication to all shareholders.

3) The Board will ensure that the company publishes accounts under GAAP or an equivalent method as follows:

- Annual for 1999
- Semiannually for 2000
- Quarterly for 2001.

The accounts, audited by an internationally recognized firm, should be published within the same time frame as comparable international companies as soon as possible and no later than in 2003.

4) Transactions with friendly parties, if any, will be on an arm's-length basis and reported when applicable.

5) The company will organize the issuance of ADR level 1 within a year and of level 2 or 3 within 3 years. It will propose to the shareholders meeting, within a year, a new effective and independent registrar of the company's shares.

6) The Board will approve a new incentive scheme for senior managers of the company that will be based mainly on profitable growth, individual contribution and the stock price performance of the company. This is intended to be implemented for the results of the year 2000.

7) Payment of dividends will be made within 3 months of its declaration by the Shareholders Meeting.

## **Corporate Governance Memorandum of AO Sibneft**

### **A MESSAGE FROM THE COMPANY PRESIDENT**

The Board of Sibneft is committed to the implementation of corporate governance as set out in the accompanying report of independent experts. We have adopted their recommendations in full and approved the following documents as the Sibneft Charter. We will work over the coming year to put the report into practice. We hope that this new level of corporate governance best practice and a commitment to transparency will set a new benchmark for major Russian companies. As the Russian corporate sector develops and becomes internationally competitive, leading Russian companies should look to adopt international standards of corporate governance. This, we believe, is not just good for investor confidence but fundamentally good for business as well.

I am very grateful to the members of the committee for all the time and effort they spent in putting together this document, and I look forward to reporting our progress to you in the coming year.

Eugene Shvidler  
AO Siberian Oil Company  
4 Sadovnicheskaya St  
Moscow, Russia

### **PRINCIPLES**

Sibneft is committed to the principles and implementation of good corporate governance. The company recognizes the valuable contribution that it makes to long-term business prosperity, to ensuring accountability to its shareholders and to developing and sustaining effective relationships with its stakeholders.

The Board is accountable to all of its shareholders and has responsibility for relationships with its stakeholders – employees, customers, suppliers, lenders, local communities and governments.

The Board will ensure that the company is managed in a way that maximizes long-term shareholder value and which takes into account the interests of all of its stakeholders.

Sibneft places considerable emphasis on the appointments of independent Non-executive Directors. They have an essential role in adding value to the company's strategic decision making as well as monitoring the company's progress.

Sibneft is committed to the equitable treatment of all of its shareholders. So far as it is practicable, the company will ensure equality of access to information for all shareholders.

Sibneft believes that full disclosure and transparency in its operations are the cornerstones of good governance. Its communications policy will reflect this.

## **BOARD**

The Board is responsible for setting the company's strategic direction, for leading and controlling the company and for monitoring activities of the executive management. At least 25 percent of the Board or three members of the Board, whichever is the greater, will be Non-executive Directors. They will be independent of management and free from any constraints which could materially interfere with the exercise of their independent judgement.

The Board will meet at least six times a year. The Chairman/Chairwoman of the Board in consultation with the Chief Executive Officer will establish the agenda for each Board meeting.

The Chairman/Chairwoman will be responsible for ensuring that all members play a full part in its activities.

The Chief Executive Officer will implement the management strategies and policies adopted by the Board and will normally be a separate individual from the Chairman/Chairwoman.

The Board will present a balanced and understandable assessment of the Company's progress and prospects.

The Board will maintain a sound system of internal controls to safeguard shareholders' investments and the company's assets.

The Board will be supplied with information and data in such a form and quality appropriate for it to discharge its duties effectively.

## **THE COMMITTEES**

The Board will assign certain functions to Board Committees which will report back to it. The main Board Committees consist of the Nomination Committee, the Remuneration Committee and the Audit Committee. The terms of reference of each committee will be determined by the board.

When and if the need exists, the Board may want to form new committees and will assign Board members to these.

The Chairman/Chairwoman of each committee will be appointed by the Board and, in consultation with the members, will determine the frequency and length of the meetings of individual Committees.

The Chairman/Chairwoman of each committee, in consultation with appropriate members of Management and Staff, will develop the individual Committee's agenda.

The Committees will be supplied with information and data in such a form and quality appropriate for them to discharge their duties.

## **DIRECTORS**

All company directors are accountable to the company's shareholders and have a responsibility to carry out their work with loyalty, prudence, and skill.

## **NON-EXECUTIVE DIRECTORS**

Non-executive Directors will exercise their independent judgment. These directors must have a knowledge of and experience with global industrial issues, overseas markets, financial and economic matters, and/or other types of business information necessary to make a valuable contribution to the company's progress.

## **NOMINATION AND ASSESSMENT COMMITTEE**

The Nomination and Assessment Committee will make recommendations to the full Board for the appointment of new Executive and Non-executive Directors when appropriate. The Committee will review, at least on an annual basis, the relevant skills and characteristics required of Board members based on the company's current business needs. The committee will report annually to the Board on the Board's performance. The assessment will specifically review areas where it is believed a better contribution could be made. Its purpose is to enhance the effective operation of the Board.

## **RE-ELECTION**

All Directors will be required to submit themselves to shareholders for re-election at regular intervals, at least every three years. All names submitted for election will be accompanied by biographical details.

## **DIRECTORS' REMUNERATION**

The company will establish a Remuneration Committee, composed of Non-executive Directors, advised by senior staff. The Committee will advise the Board on the appropriate framework for the remuneration of Directors. Directors will not participate in the decision of their own remuneration. Remuneration levels will be set at such a level as to attract and retain Directors of the required calibre.

## **AUDIT ACCOUNTABILITY**

The company will establish an Audit Committee to consider the Report and Accounts. The Committee will be composed solely of Non-executive Directors, advised by the Chief Financial Officer and other senior staff as appropriate.

Its duties will also include keeping under review the scope and results of the audit and its cost effectiveness, as well as the independence and objectivity of the auditors.

The Audit Committee will also keep under review financial management, financial and risk controls, compliance with laws and regulations, technical reviews, the safeguarding of assets and business risk assessment and response.

In carrying out its duties, the Audit Committee may, at its discretion, consult alone with internal and external auditors and other relevant bodies.

The Audit Committee will report regularly to the Board and, at least, annually.

## **SHAREHOLDERS**

The company recognizes the importance of dialogue between present and potential investors and to a long-term commitment to the market in which it operates.

The company's communications policy is committed to ensuring enhanced information flows between investors and the company through all forms of media, including electronic media.

It is also committed to ensuring that there is regular systematic contact and communications between the company and investors on its strategy, performance targets and its performance against these targets.

## **COMMUNICATIONS**

The company will publish this corporate governance policy and report on the progress of its implementation in its Annual Report and to its Annual General Meeting.

## **CORPORATE GOVERNANCE COMMITTEE**

Sir Geoffrey Owen - Director, Business Policy Programme at the London School of Economics (1991 - to date). Editor of the Financial Times (1981 - 90).

Jonathan Charkham - Adviser to the Governor of the Bank of England (1988 - 93), Director of PRO NED (1982 - 85), currently Non-Executive Director of Great Universal Stores plc, CrestaCare plc, CLM plc and Leopold Joseph Holdings plc as well as author of 'Keeping Good Company' (1994), a survey of corporate governance in five countries

Jack Spinks - Director of Planning for Shell UK, Exploration and Production Division (1949 - 82). Senior Oil Consultant to the Bank of Scotland (1982 - 86), and Non-Executive Director of GOAL Petroleum (1986 - 94).

Simon Walker - Director of Communications, British Airways plc. Former partner Brunswick Group Limited (1994 - 98), seconded to No. 10 Downing Street Policy Unit where his responsibilities included financial regulation (1996 - 97), Director of European Public Affairs, Hill and Knowlton, Brussels (1990 - 94).

## **Corporate Governance Memorandum of AO Lenenergo**

### **STRATEGIC OUTLOOK**

The overall strategic goal of the Company's economic activity is to find and consolidate a good position within the emerging European energy market using its traditionally strong consumer basis in its long-standing Russian supply area and the geographic proximity to the NORDEL- and CENTREL-countries (Baltic Region).

It is understood by the Company's management that the prerequisite for this strategic endeavour is to permanently consolidate the Company's leading position within the Russian North-West system. The Company will in the medium and in the long term strive for an active participation in the consolidation process within the Russian electricity industry. Henceforth, the principal activities described hereinafter will provide the Company with the necessary economic strength to achieve these strategic targets.

### **PRINCIPAL TARGETS AND ACTIVITIES**

The Company is determined to focus its activities on its core business – electricity and heat generation, transmission, and distribution. The overall target is to re-establish the Company's economic stability and, then, to regain a permanently profitable position. In this respect it is understood to continue, strengthen and initiate the following prior activities:

#### **Improvement of collection rates and payment discipline**

- The company sets-up payment targets, particularly for its key-account clients, and would undertake any measure within legal scope and economic reason to put its claim through. Payment targets are subject to upward revision on a regular basis.

#### **Cost cutting**

- The Company has permanent control over its cost structure and undertakes the necessary measures to reduce/eliminate the cost of unjustified or inappropriate business procedures. (This also implies the transfer or selling of activities which are not in the scope of business, such as social sphere, banking, etc.) The Management regularly revises results and sets-up quantitative cost cutting targets, thus enhancing efficiency (cost controlling).

- It also carries out a strict procurement policy submitting the purchase of goods and services to a well defined tender procedure.

#### **Business consolidation and long-term expansion with an increase in profitable turn-over**

- The Company undertakes everything in its reach to establish normal relations with the federal, regional and municipal authorities in order to achieve and maintain economically justified tariffs, thus, preventing the Company from officially pre-defined loss-making.

- The Management pursues a general policy of full understanding with the Company's clients and will apply its economic strength to provide them with reasonably priced good-quality services.

- The Management seeks to settle the relation with energy re-sellers with the overall

aim to take over their assets, thus, preventing the Company from loss-making.

## **SHAREHOLDERS AND INVESTORS RELATIONS**

The Company's management has a clear understanding that trust and confidence of shareholders and investors in the Company's economic stability and good managerial practice represents one of the most important preconditions for their willingness to invest their capital and to actively support the Company's projects and activities, thus, for any business success of the Company. This is even more important in a business environment which seems more often than not rather unappealing to the international and domestic business community due to periodical general crisis, prohibiting/non-friendly legislation etc.

For that reason the Company's management is determined to substantially improve the relations with its shareholders, with strategic and main stakeholders in particular, and investors. It will focus its activities on the following targets:

### **Strict defence of shareholders and investors' rights**

- The Company will thoroughly obey Russian legislation and internationally approved good management practice to guarantee a maximum protection of all of its shareholders and investors against any influence, measures etc. which could restrict them in obtaining and executing their rights.
- Given the important role the Company's strategic stakeholders could take over the Management will undertake considerable efforts to improve their integration into all important fields of business. For this matter, the Board of Directors will represent the required auditory for information and decision making and, thus, the efficient link between the Company and its main stakeholders.
- The protection of shareholders' and investors' rights is particularly sensitive and is, therefore, prioritized by the Company's Management in the following business areas: asset transfer and all similar property related questions, debt restructuring, possible raise in equity capital/share emission and information policy.

### **Information transparency**

- It is understood that the required confidence of shareholders and investors largely depends on the Company's transparency in regard to its financial and operational activities, thus, on the regular, true and comprehensible information provided by its Management.
- The Management and the Board of Directors will define and communicate to all shareholders efficient, hindrance - free rules how to obtain more detailed information on the Company's economic situation.
- The Company will use the available modern means of communication to spread the Company's information efficiently.
- The Management and the Board of Directors undertake steps to introduce internationally recognized accounting standards in order to improve the degree of understanding. The latter will also be reached by the introduction of English versions of all important information documents (Annual reports, Quarterly reports, WEB-site, Facts and Figures etc.)

The present memorandum is approved by the Company's Board of Directors and its Management represented by its CEO. It will be distributed on a large scale, particularly to the Company's shareholders, present and future investors, the financing

institutions, authorities and within the energy sector.

The execution and implementation of the main corporate governance principles is in the responsibility of the Company's management and will periodically be revised and actively supported by the Company's Board. The Company will inform on results and progress.

Saint-Petersburg, June 2000

Board of Directors

Chief Executive Officer

### Results of S&P Russian Transparency and Disclosure Survey <sup>29</sup>

		Total	Block 1	Block 2	Block 3
1	MTS	77%	77%	79%	75%
2	Wimm-Bill-Dann	73%	83%	80%	56%
3	YUKOS	52%	40%	67%	45%
4	VimpelCom	49%	33%	77%	26%
5	Golden Telecom	49%	18%	73%	48%
6	Rostelecom	48%	52%	56%	35%
7	Sibirtelecom	45%	46%	50%	38%
8	MGTS	45%	41%	55%	35%
9	LUKOIL	44%	42%	57%	30%
10	RAO UES	43%	41%	52%	33%
11	North-West Telecom	42%	49%	39%	39%
12	Norilsk Nickel	42%	35%	47%	40%
13	Sibneft	43%	29%	56%	39%
14	Lenenergo	39%	44%	36%	37%
15	Mosenergo	39%	32%	52%	28%
16	Bashkirenergo	38%	40%	39%	36%
17	Center Telecom	38%	41%	35%	39%
18	Samaraenergo	38%	32%	41%	39%
19	Aeroflot	36%	27%	49%	27%
20	MMK	36%	40%	37%	30%
21	Surgutneftegaz	34%	23%	47%	26%
22	Tatneft	33%	21%	53%	17%
23	Volga Telecom	30%	32%	34%	23%
24	Irkutskenergo	30%	21%	41%	23%
25	Uralsviazinform	29%	30%	27%	31%
26	South Telecom	29%	27%	35%	24%
26	Sberbank	28%	19%	39%	20%
28	Baltika	27%	22%	41%	12%
29	Gazprom	26%	30%	23%	27%
30	UHM	26%	20%	35%	20%
31	TNK	26%	25%	32%	18%
32	Krasnoyarskenergo	25%	25%	25%	26%
33	Severstal	25%	23%	26%	26%
34	Permenergo	23%	28%	20%	22%
35	Sverdlovennergo	31%	38%	27%	28%
36	Bashinformsvyaz	21%	19%	22%	23%
37	GUM	19%	17%	20%	19%
38	Rostovenergo	17%	15%	17%	18%
39	Red October	15%	12%	17%	13%
40	Kuzbassenergo	14%	10%	17%	15%
41	AvtoVAZ	14%	11%	18%	13%
42	GAZ	10%	9%	9%	12%

## Notes

- <sup>1</sup> Igor Belikov, Director, Russian Institute of Directors.
- <sup>2</sup> Source: Dimitry Vasiliev, Executive Director of the Institute of Corporate Law and Corporate Governance.
- <sup>3</sup> Copies of most governance-related laws, including the amended Joint Stock Company Law, can be found at the websites of the Federal Commission for Securities Market, [www.fcsm.ru](http://www.fcsm.ru); the Russian Institute of Directors, [www.rid.ru](http://www.rid.ru) and Corporate Governance in Russia: [http://www.corp-gov.org/bd/index.php3?base\\_id=1](http://www.corp-gov.org/bd/index.php3?base_id=1). Most laws are available only in Russian. The Institute of Corporate Law and Corporate Governance is also a good source of information on Russian legislation: <http://www.iclg.ru/>.
- <sup>4</sup> For a list of the specific items required by the law see the appendix.
- <sup>5</sup> The term "board of directors" will be used throughout this paper to refer to the supervisory board in a two-tier board structure.
- <sup>6</sup> A number of terms are used to translate this Russian structure into English. It has been referred to as an audit commission, audit committee and revision commission. For the purposes of this paper the term "revision commission" is used to distinguish it clearly from an audit committee, which has distinct functions and responsibilities.
- <sup>7</sup> The terms "executive board" and "management board" are both used to refer to the executive part of the board under a two-tier board structure. The term "management board" is used for the purposes of this paper.
- <sup>8</sup> Source: Dimitry Vasiliev, Executive Director of the Institute of Corporate Law and Corporate Governance.
- <sup>9</sup> For a more complete list of requirements see the appendix.
- <sup>10</sup> Gennady Kolesnikov, Deputy Chairman, Federal Commission for Russian Securities Market.
- <sup>11</sup> Excluding bank accounting standards, which are set by the Central Bank.
- <sup>12</sup> The Russian deadline of 2004 for convergence may appear ambitious since the European Union has set its deadline for 2005. A number of other convergence plans have been discussed, some envisioning transition periods of up to 10 years. Investors, on the other hand, would like to see immediate changes.
- <sup>13</sup> For a full list of the differences see "GAAP 2001, A Survey of National Accounting Rules Benchmarked Against International Accounting Standards" at: [http://www.ifad.net/content/ie/ie\\_f\\_gaap\\_frameset.htm](http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm).
- <sup>14</sup> "GAAP Convergence 2002: A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards".
- <sup>15</sup> [www.micex.com](http://www.micex.com).
- <sup>16</sup> [www.rts.ru](http://www.rts.ru)
- <sup>17</sup> RAO UES, LUKoil, Mosenergo and Sberbank.
- <sup>18</sup> RAO UES, LUKoil, Surgutneftegaz, Yukos, Mosenergo and MMC Norilsk Nickel.
- <sup>19</sup> See appendix for a list of companies surveyed by S&P and their disclosure rankings.
- <sup>20</sup> Similar structures may be found in other countries, for example Italy and Brazil.
- <sup>21</sup> Kirill Ratnikov, Partner, Coudert Brothers LLP, in interview with the Russian Institute of Directors.
- <sup>22</sup> Igor Belikov, Director, Russian Institute of Directors.
- <sup>23</sup> Source: Resolutions of the 5<sup>th</sup> Council for Corporate Governance.
- <sup>24</sup> Igor Belikov, Director, Russian Institute of Directors.
- <sup>25</sup> Natalia Annikova and Igor Belikov, the [Institute of Capital Market and Management](http://www.instituteofcapitalmarketandmanagement.ru).
- <sup>26</sup> Source: the Institute of Corporate Law and Corporate Governance. Website: <http://www.iclg.ru/enlaw1>.
- <sup>27</sup> Source: the Institute of Corporate Law and Corporate Governance. Website: <http://www.iclg.ru/enlaw1>.
- <sup>28</sup> Source: Igor Belikov, Director, Russian Institute of Directors.
- <sup>29</sup> The survey primarily analyzes disclosure from an international investor's perspective and measures the inclusion of 98 items relating to: Block 1 Ownership structure and investor relations; Block 2 Financial and operational information; and Block 3 Board and management structure and processes. The studies are based on documents most commonly available to investors (typically English and local language annual reports). In certain cases, including that of Russia, regulatory filings have been used where these are the primary public reference document. The survey used data for Russian companies until Aug. 13, 2002.

# **CHAPTER VI**

## **CASE STUDY ON CORPORATE GOVERNANCE DISCLOSURES IN THE UNITED STATES OF AMERICA**

### **I. INTRODUCTION**

The United States has the largest and, arguably, the most developed securities market in the world. The US market includes over 17,000<sup>1</sup> publicly traded companies, with a total market capitalization in the region of approximately US\$12 trillion.<sup>2</sup> Its long history of regulation began in the Great Depression and resulted in the securities and banking acts of the 1930s that have provided the legal framework for the markets ever since.

Corporate governance was catapulted into the public spotlight late in 2001 because of the failure of Enron. Enron, by now a household name, was the largest bankruptcy in US history. It resulted in the loss of over 21,000 jobs, the disappearance of over US\$1.2 billion in employee savings, and was an important factor in the closing of one of the world's most prestigious audit firms. Enron's failure was accompanied by failures among every conceivable corporate watchdog ranging from auditors to investment banks, ratings agencies, analysts and regulatory organizations.

Although the causes of Enron's downfall are many, much of its demise was blamed upon its accounting and reporting practices. Industry officials and academics surmise that a number of factors may have caused US companies to use questionable accounting and disclosure practices, including a) pressure to meet quarterly earnings projections and maintain stock prices after the expansion of the 1990s; b) executive compensation practices; c) outdated and rules-based accounting standards; d) complex corporate financial arrangements designed to minimize taxes and hide the true state of the enterprise; and e) the compromised independence of public accounting firms.<sup>3</sup>

The result has been a tremendous push to improve governance and disclosure practices through legislation, regulation, stock exchange rules and private sector efforts. The outcome is the Sarbanes-Oxley Act of 2002 (SOA), new US Securities and Exchange Commission (SEC) regulations implementing the Sarbanes-Oxley Act and new rules for the major US exchanges.

This case study focuses on post-Enron era reforms, and describes efforts to address what went wrong. An extensive appendix is included to provide the reader with further details on legislation and regulation, and references are included to lead the reader back to original sources. Included in the appendix is a comparison of US governance disclosure practice as compared to the ISAR Transparency and Disclosure Requirements for Corporate Governance.

## **Public Sector Initiatives**

Full and fair disclosure of information by issuers of securities is a cornerstone of federal securities laws. In enacting mandatory disclosure under the Securities Exchange Act of 1934 (the “Exchange Act”), the US Congress sought to promote disclosure of complete and correct information to facilitate the operation of fair and efficient markets. Since then, a considerable body of law has been developed to enhance the quality of US financial markets.

### **A. Congressional legislation**

The most recent of these laws, the Sarbanes-Oxley Act of 2002, signed into law on 30 July 2002, created the most radical redesign of federal securities laws since the Exchange Act in the 1930s. The Sarbanes-Oxley Act contains the blueprint for regulations that would have been inconceivable before Enron. It is worth noting that while the US securities market regulation has traditionally been disclosure-based, the SOA has broken with tradition by introducing more substantive requirements for corporate governance. Progress on the adoption of rules has been rapid by any standard; the act mandates implementation periods ranging from the immediate to no longer than one year.

#### **The key provisions of the Sarbanes-Oxley Act are:<sup>4</sup>**

*Title I, Public Company Accounting Oversight Board:* Title I establishes the Public Company Accounting Oversight Board (PCAOB), an independent non-governmental body, to regulate accounting firms and to restore the confidence of the investing public in independent audit reports. The SEC retains oversight and enforcement authority over the PCAOB. Foreign public accounting firms are subject to the requirements of the SOA when providing reports on issuers in the United States. The PCAOB is to be operational by 26 April 2003, whereupon public accounting firms have 180 days to register with the Board.

*Title II, Auditor Independence:* This Title addresses auditor independence, the scope of services that can be provided to audit clients and audit partner rotation. Certain non-audit services, such as bookkeeping, internal audit, human resources related services, and legal and actuarial services, are specifically prohibited. The same accounting firm is prohibited from providing both audit and non-audit services to a company, subject to exceptions that must be approved by a company’s audit committee. Companies must rotate their accounting firms’ lead audit partner and the firms’ reviewing partner every five years. The auditor reports directly to the board’s audit committee, which is responsible for choosing, compensating and overseeing the audit firm. In addition, a study of the concept of mandatory rotation of audit firms is to be completed by 30 July 2003.

*Title III, Corporate Responsibility:* This Title requires corporate audit committee and CEO and CFO certifications of quarterly and annual statements, and establishes rules of conduct for attorneys. It establishes tougher penalties for various aspects of corporate fraud, including knowingly shredding records with the intent of obstructing investigations. Penalties and forfeiture of bonuses apply to CEOs and CFOs if the issuer is required to restate owing to non-compliance with financial reporting requirements.

*Title IV, Enhanced Financial Disclosure:* The Title seeks to tighten disclosure of off-balance-sheet items and enhance disclosure of conflicts of interest. It requires disclosure of management's assessment of internal controls, and disclosure of a code of ethics for senior financial officers. Public disclosure of material events must be made more quickly and clearly. It requires real-time disclosure of material financial and operational information that could include trend and qualitative information. It also requires disclosure to be in "plain English", that is, fully comprehensible to the reader.

*Title V, Analyst Conflicts of Interest:* This Title requires that brokers, dealers and analysts, and others involved in providing recommendations certify in their reports that their recommendations correspond to their own personal views and that they did not receive compensation or recognition that might have influenced their views.

*Title VI, Commission Resources and Authority:* Among other things, this Title authorizes additional appropriations for the SEC.

*Title VII, Studies and Reports:* Title VII directs federal institutions to conduct studies on (a) the impact of the consolidation of large accounting firms and possible anti-competitive behaviour; (b) impediments to the accurate appraisal of credit rating agencies, and possible conflicts of interest and barriers to entry into the credit rating industry; (c) a study of violators and violations of securities law by securities professionals (defined as accountants, accounting firms, brokers, dealers, attorneys, investment advisers, investment bankers and others); (d) a review of SEC enforcement actions relating to disclosure requirements; and (e) a study of investment banks to see whether they manipulated earnings and concealed the true financial condition in the cases of Enron and Global Crossing.<sup>5</sup>

*Title VIII, Corporate and Criminal Fraud Accountability:* Title VIII, or the "Corporate and Criminal Fraud Accountability Act of 2002", provides for tough new fines and imprisonment for altering financial records. The Title also provides, among other things, for the maintenance of audit records for a minimum of five years, protection for employees who signal fraud to authorities ("whistle blowers") and an extension of existing statutes of limitations for securities fraud.

*Title IX, White Collar Crime Penalty:* Title IX, the White-Collar Crime Penalty Enhancement Act of 2002, increases various penalties for white-collar crime. Penalties for CEOs and CFOs who falsely certify quarterly or annual statements range up to \$5 million and 20 years, imprisonment.

*Title X, Corporate Tax Returns:* This Title conveys the "sense" (or position of the Senate) with respect to CEO certification of a company's tax returns. A "sense" is not a law. In order for it to have the effect of law, further legislation needs to be passed. The Senate, at present, favours such certification.

*Title XI, Corporate Fraud and Accountability:* Title XI, also referred to as the Corporate Fraud Accountability Act of 2002, provides for further penalties for

tampering with records or otherwise impeding an official proceeding. It also provides for penalties for retaliation against informants or whistle blowers.

The breadth of the SOA is worth noting. Its reach reflects the perception that problems found at Enron were not isolated, but rather of systemic origin. What is striking about the US failures is that all of the elements of the system designed to check corporate abuses failed, simultaneously, to one degree or another: investment intermediaries – caught in conflicts of interest between investment banking clients and investors – provided faulty advice; law firms and audit firms held their clients' interests before the law; boards were unable to stand up to management; the business press and analyst community did not dig deeply enough; accounting standards were no match for the determined wrong doer and their financial advisers; and regulators were unable to detect the extent of manipulation. As a consequence, Congress appears to have attacked the problem on all fronts.

One can already discern the focus of future legislative and regulatory attention by looking at the reports and studies that were commissioned by the Sarbanes-Oxley Act. Of the eight studies called for in the act, a number cover governance and disclosure related topics of interest to ISAR. These include (a) the effects of consolidation in the accounting industry; (b) mandatory rotation of auditors; (c) the effects of rules-based accounting; and (d) the effects of off-balance sheet transactions. Other studies will explore conflicts of interest among credit rating agencies and investment banks, and violations of securities law.

Four studies were completed at the time of writing of this report.<sup>6</sup> Some of the major conclusions are:

- Accounting failures have increased significantly in recent years.
- Revenue recognition is the principal accounting problem, followed by questions of expense recognition, accounting for reserves, accruals and contingencies, improper equity accounting, and others.
- Restatements cause significant decreases in stock prices in individual companies and seem to have a ripple effect on investor confidence and market trends.
- Large numbers of restatements seem to shake faith in the financial system and the integrity of markets, and cast doubt upon the system of governance and disclosure.
- Many areas of financial reporting are susceptible to fraud and manipulation.
- Auditor violations arise most often from accepting management representations without verification, improper analytical and substantive procedures, and failure to gain sufficient evidence.
- Recommendations should be made to improve uniform reporting of restatements and improved Management's Discussion and Analysis disclosure among others.

While US disclosure rules have long been a model for much of the world, considerable work could be done to make them stronger still. Focus areas will likely be specific accounting standards in the areas of revenue recognition, off-balance sheet transactions, stock option accounting and Special Purpose Entities (SPEs), as well as more general problems arising from a system of rules-based accounting. Further

attention will almost certainly be devoted to the question of the independence of auditors.

## **B. United States Securities and Exchange Commission (SEC) Rules and Regulations**

The laws and rules that govern the securities industry in the United States derive from the concept that investors should have access to clear and relevant information about an investment before buying. One of the primary functions of the US SEC is therefore to require public companies to disclose financial and non-financial information for investors and to ensure equal access to this information.<sup>7</sup>

Crucial to the SEC's effectiveness is its enforcement ability. While small compared with other federal agencies (the SEC has approximately 3,000 employees), it has far more manpower than what is available to market oversight bodies in other countries. With its current resources, the SEC brings between 400 and 500 civil enforcement actions against individuals and companies that break the securities laws each year. The current size and resources of the SEC are, nevertheless, considered inadequate to meet the new demands of oversight and fraud-related enforcement in the wake of Enron.<sup>8</sup>

The SEC has not been spared from criticism. It has been suggested that Enron and other cases of corporate misconduct are cause for the SEC to re-examine the way it operates, particularly, its reliance on private sector gatekeepers to ensure the flow of honest and accurate information. Given the failure of some of these gatekeepers to catch numerous cases of misreporting, the SEC may need to find ways to more proactively detect and root out financial fraud.<sup>9</sup>

### **SEC final rules implementing the Sarbanes-Oxley Act**

Much of the SEC's efforts in the second half of 2002 and early 2003 was devoted to the development of final rules implementing the Sarbanes-Oxley Act. Some 18 rules were approved in less than one year; these adhere closely to the act and build upon it with further details. A summary of the main disclosure related elements follows.<sup>10</sup>

*CEO/CFO certification of financial reports:* The Final Rule issued on 29 August 2002 in response to Section 302 of the SOA, "Corporate Responsibility for Financial Reports", requires that the CEO and CFO certify that: (a) they have reviewed annual and quarterly reports; (b) they contain no misrepresentations; (c) the financial information is fairly represented; (d) they are responsible for disclosure controls and procedures; (e) they have reported any deficiencies in control and fraud to the audit committee; and (f) they have indicated any material changes in internal controls. With respect to Section 403 of the SOA, "Disclosure of Transactions Involving Management and Principal Shareholders", the rule requires accelerated reporting of insider stock transactions; transactions between officers or directors and the issuer must be reported within two business days.

*Accelerated filings:* A Final Rule issued on 5 September 2002 further accelerates filings.

*Pro-forma statements:* The Final Rule issued on 22 January 2003, responds to Section 401(b) of the SOA on the use of non-General Accepted Accounting Principles pro-forma financial information. The SEC now requires public disclosure of pro-forma information in its closest GAAP form and reconciliation to GAAP.

*Codes of ethics:* This Final Rule issued on 23 January 2003 relates to Section 406 of the SOA, which deals with senior management codes of ethics. It requires disclosure in the annual report of whether a company has adopted a code of ethics for the principal executive and financial officers, and, if not, the reasons why. With respect to Section 407 of the SOA on the disclosure of the audit committee financial expert, the rule requires a company to disclose whether it has at least one “financial expert” on its audit committee and, if not, to explain why. The name of the expert must be disclosed, as does whether or not he or she qualifies as an independent director.

*Penalties for altering documents:* A Final Rule issued on 24 January 2003 responds to Section 802 of the SOA. It provides for criminal penalties for altering documents, and extends the retention period for auditors specified by the SOA from five years to seven years. Information related to a significant matter that is inconsistent with the auditor’s final opinion also needs to be retained.

*Off-balance sheet transactions:* The Final Rule issued on 27 January 2003, relates to Section 401(a) of the SOA on off-balance sheet transactions. It requires disclosure in the MD&A of all off-balance sheet arrangements that are reasonably likely to have a material effect on the statements, and requires a summary of other contractual obligations.

*Strengthening auditor independence:* This Final Rule issued on 28 January 2003 implements a number of measures to strengthen auditor independence by identifying services that would impair independence. Prohibited services include (a) bookkeeping; (b) financial information system design and implementation; (c) appraisal or valuation services, fairness opinions or contributions-in-kind reports; (d) actuarial services; (e) internal audit outsourcing services; (f) management functions; (g) human resource services; (h) broker-dealer, investment advisor, or investment banking services; (i) legal services; (j) expert services unrelated to the audit; and (k) any other services that the PCAOB determines impermissible. Tax services would be permissible.

With respect to Section 202 of the SOA, audit committees are required to pre-approve all audit and non-audit services, and not delegate this responsibility to management. With respect to section 203, the Final Rule requires lead and concurring partner rotation after five years and a five-year “time-out” period. With respect to section 204, the Final Rule requires the auditor to report to the audit committee before filing of the report on (a) critical accounting policies; (b) alternative treatments discussed with the client; (c) any material written communications with management.

*Analyst, broker and dealer disclosures:* This Final Rule was issued on 20 February 2003. Called “Regulation Analyst Certification”, it requires brokers, dealers and others to certify their research reports as their own opinions.

*Standards relating to audit committees:* The Final Rule issued on 9 April 2003 was the most recent rule at the time of the writing of this report. “Standards Relating to Listed Company Audit Committees” prohibits the listing on US exchanges of companies that do not comply with the audit committee requirements of the SOA.

### **Regulation Fair Disclosure or Regulation “FD”<sup>11</sup>**

Seemingly forgotten in the race to complete regulations as directed by the Sarbanes-Oxley Act was the SEC’s Regulation Fair Disclosure or Regulation “FD”. At the time it became effective in October 2000, it was hailed as a piece of landmark regulation. Though more recent rule making surpassed its prominence, it remains an important and interesting element of SEC regulation. In brief, the regulation is designed to eliminate “selective disclosure” by levelling the playing field between investors. It stipulates that material information disclosed to analysts or other members of the investment community be made available simultaneously to the investing public.

Federal securities laws prior to Regulation FD did not generally require issuers to make public all material developments as they occurred. As a result, companies could control who received important information that was used in determining stock prices. This allowed issuers, in some cases, to selectively disclose information to favoured analysts or institutional investors prior to making a broad disclosure via a press release or an SEC filing.

Regulation FD bars disclosure to selected analysts, funds or individual investors before the information is made available to the public. If a disclosure occurs unintentionally, the violation must be rectified within 24 hours in order to avoid being qualified as selective. The Regulation does not mandate that issuers make public disclosure of all material developments when they occur, but rather requires that when issuers choose to disclose material information, they do so broadly to the investing public.

Regulation FD was hotly debated when it was enacted. Representatives of industry and the analyst’s profession<sup>12</sup> spoke out strongly against it. The substance of their concern was that less information would be disclosed as a result of fears over potential litigation. They were also concerned about increased “boilerplate” disclosure and reduced transparency that would eventually result in greater market volatility. Individual investors, on the other hand, praised the fairness of the regulation while decrying the analysts’ position as trying to maintain their privileged access to information. Ultimately, studies indicated that regulation FD had not reduced the amount or quality of information that companies make available to the public.

The first SEC enforcement actions relating to Regulation FD were made public in November 2002. Some of the first four violations appear to result from unintentional oversights while others are attributable to clear lapses in judgement on the part of executives. All of the sanctions were imposed as part of settlements with

the SEC, and none of the companies involved admitted or denied any of the findings.<sup>13</sup>

The legislation, rules and regulations summarized above are a broad-reaching set of reforms that represent a considerable strengthening of governance and governance-related disclosure in the United States.<sup>14</sup> The US approach over the past year, developing regulation on a broad number of fronts, is based upon an understanding of the problem as one of a systemic nature. While broad in the sense that it covers many industries, it is also tightly focused on the information provided to the markets and the certification and independent verification of information.

The new regulations also provide for tough penalties and additional resources for regulatory agencies, thus recognizing that failure often occurs at the level of enforcement. It is too early to say what the results will be, although there is some anecdotal evidence that companies and financial service providers are adapting their practices. After the fast-paced legislative response over the past year, the US Government will likely wait to see what happened in the private sector before undertaking further actions.

### **C. The private sector**

#### **The Financial Accounting Standards Board (FASB) Accounting Standards**

The US SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the SEC has relied on the private sector for this function to the extent that the private sector demonstrates ability to fulfil this responsibility in the public interest.

The Financial Accounting Standards Board (FASB) was established in 1972. Its mission has been to establish and improve standards of financial accounting and reporting for the guidance of issuers, auditors and users of financial information.

Since Enron, there have been increasing calls to make fundamental changes in FASB standard setting and SEC oversight. In congressional testimony, Robert K. Herdman, Chief Accountant of the SEC, advocated revamping certain aspects of FASB's operations. Herdman summarizes the key issues as: (a) a standard-setting process that is too cumbersome and slow; (b) overly complex guidance that reduces transparency; and (c) rules-based accounting that obscures the true position of the enterprise.<sup>15</sup>

Publicly, it has not gone unnoticed that FASB standards were easily subverted by Enron and other corporations intent on misleading shareholders. Detailed rules are intended to reduce the use of alternative approaches and, in turn, reduce the potential for errors in judgement and manipulation in reporting. However, rules-based standards can make it more difficult for preparers and auditors to step back and evaluate whether the overall accounting corresponds to the objectives of disclosure—namely, the rendering the company's position accurately, and providing investors with better insight. In practice, compliance with the letter of the standard (as opposed to its spirit) is easily achieved while distorting the big picture.

There are also concerns regarding weak public sector oversight and governance at FASB.<sup>16</sup> The Financial Accounting Foundation, the oversight body that appoints the members of FASB, is composed almost entirely of investors, business people and accountants. Critics also point to potential conflicts of interest at the Accounting Standards Executive Committee (AcSEC). AcSEC is FASB's secondary standard setter and a committee of the American Institute of Certified Public Accountants (AICPA), the professional body representing Certified Public Accountants in the United States. FASB delegates the development of specialized standards for industries and other special issues to AcSEC.

For FASB to better fulfil its responsibilities, greater efforts may need to be made to shield it from outside political influence. In the mid-1990s corporate and congressional pressure forced FASB to back down on its proposal for accounting for stock option compensation. The proposal would have required expensing option grants and would have significantly worsened the income statement of many corporations.

On another occasion FASB attempted to improve accounting for Special Purpose Entities (SPEs). Though SPEs may serve legitimate purposes, Tim Lucas, Research Director at FASB, asserts that many companies structure SPEs in order to "escape the financial statements."<sup>17</sup> Amid strong criticism and lobbying, FASB and other financial regulators backed down, possibly missing an opportunity to rein in Enron-style reporting. While suggestions to federalize FASB do not appear to be receiving serious consideration, there appears, nevertheless, to be considerable scope for improving FASB's governance and operations.

With respect to International Financial Reporting Standards, the FASB has formal plans for eventual convergence, a process that may be assisted by the fact that the current President, Bob Herz, was a former Board Member of the International Accounting Standards Board. Numerous differences exist between US GAAP and IFRS, some of which can result in significant differences in the financial statements.<sup>18</sup> However, the single most important impediment to convergence is the fact that the United States has a long tradition of standard setting over which it is reticent to relinquish control. Despite shortcomings, the United States is largely satisfied with the quality of its accounting standards and would prefer to improve its own standards rather than cede control over an important element of its market to other standard setters.<sup>19</sup>

## **Stock Exchanges**

The three major exchanges in the United States are the American Stock Exchange (AMEX), the NASDAQ and the New York Stock Exchange (NYSE). All have proposed changes to their listing rules in order to strengthen the governance and disclosure of listed enterprises.<sup>20</sup> These proposals were filed with the SEC. Recently, the SEC approved some of these proposals. The following points cover the main items pertaining to disclosure.<sup>21</sup>

*Disclosure of corporate governance guidelines:* Issuers on the AMEX and the NYSE need to adopt and disclose guidelines on corporate governance. The NYSE requires disclosure of director, qualifications; responsibilities; access to management

and independent advisers; compensation; orientation and succession issues; and annual performance evaluations. The NYSE also requires that the CEO certify in the annual report that he or she is not aware of any material violation of NYSE governance standards.

*Disclosure of the determination of the independence of directors and director fitness:* The NYSE requires disclosure of the board's determination that directors are independent. The board may determine that a relationship exists between the company and the directors that would not materially affect independence. The basis for determining that a relationship is not material must be disclosed. The company must disclose its determination that directors who sit on more than three audit committees are fit to fulfil their responsibilities.

*Codes of ethics:* Each of the three exchanges requires companies to have and disclose codes of ethics for senior officers. The NYSE also requires disclosure of key committee charters. Both the NASDAQ and New York Stock Exchange require disclosure of waivers to the code of ethics.

*Stock option plans and stock transactions by executives:* All three exchanges require shareholder approval of equity compensation plans. The NASDAQ requires disclosure of transactions in company stock of up to \$100,000 within two business days and within two business days of the following week for smaller transactions.

*Internal audit:* The NYSE will require companies to have an internal audit function.

*Going concern:* The AMEX requires disclosure of a going concern qualification in the audit report.

*Penalties:* Each of the exchanges may issue warnings and may de-list companies for violations.

Changes in the United States can be expected to have a significant impact on foreign companies listing on the major exchanges. As the exchanges upgrade corporate governance standards for their members, they will institute "comply-or-explain" procedures for their non-American listings. In the future, foreign issuers on all three exchanges must disclose differences between their national governance practices and those specified by the exchange.

### **Major investors and investor groupings**

Most major US investors and investor groups support similar positions with respect to corporate governance. They use a variety of techniques to influence government and companies, ranging from lobbying and letter campaigns to the publication of corporate governance ratings and lists of corporate miscreants. Over the past year, investor groups seized the opportunity to press for longstanding wishes by providing congressional testimony and writing comment letters on various pieces of legislation, regulation and listing requirements.

Perhaps the best-known investor in the United States, and certainly the largest, is the California Public Employees' Retirement System (CalPERS). CalPERS has long been a leader in the governance movement and is known for its activism. Since CalPERS' investment philosophy is that of an index fund, it must hold shares in all of the companies in the market, and is not able to do the "Wall Street Walk", that is, sell shares and walk away from companies it does not like.<sup>22</sup>

Its only avenue for improving the performance of its portfolio is to improve the long-term performance of the companies it owns. CalPERS does so by encouraging better governance. In most cases it enters into a dialogue with the companies it owns. It may, however, choose to be quite active in its approach. It has an action plan that includes tough rules that require voting against directors who do not support its positions, and may strike directly at the heart of the matter by lodging lawsuits against companies for violations of shareholder rights. Through careful selection of its battles, it has been able to garner a small number of important victories that have resulted in significant amounts of money being returned to shareholders. CalPERS takes its responsibility for improving company performance beyond lobbying companies to actively lobbying government for financial market reform.<sup>23</sup>

The organization that unifies the voice of a large number of retirement funds is the Council of Institutional Investors (CII). It is composed of large public, labour and corporate pension funds, whose combined assets exceed \$2 trillion. Some of its members are the AFL-CIO Staff Retirement Plan, CalPERS, federal and state retirement plans, and the Association of World Bank Staff Retirement Plan among many others. CII has a number of programmes, including tracking shareholder-sponsored resolutions, monitoring responses to majority votes on shareholder resolutions and the publication of a list of underperforming corporations, known as the "Focus List". Its policy on disclosure is that corporations should report all information necessary for determining whether directors qualify as independent, whether or not the disclosure is required by state or federal law.<sup>24</sup>

The grouping that represents the mutual fund industry in the United States is the Investment Company Institute (ICI).<sup>25</sup> ICI echoes the major positions of other investors and investor groupings, including requiring the expensing of stock options, requiring that pro forma earnings announcements be reconciled to GAAP, expanding several types of material information disclosure, and requiring shareholder approval of stock option plans.

Most of the public sector retirement funds and investor groupings also support positions with respect to transparency on socially relevant issues. CalPERS supports the broad concept of corporate responsibility and, more specifically, the Sullivan Principles in its international proxy voting guidelines. The Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), the second largest public employee retirement fund in the United States, also makes explicit mention of social responsibility issues in its Policy Statement on Corporate Governance.<sup>26</sup> The Council of Institutional Investors, speaking for all of its members, supports the belief that the responsible conduct of business and business relationships is consistent with the fiduciary responsibility of investors and protecting long-term investment interests.

Unions are also major investors in the United States. The AFL-CIO uses the considerable weight of workers' pension funds to demand corporate accountability through shareholder actions. It proposes a new, higher corporate governance standard for companies traded on major US stock exchanges that would include accounting for stock options at cost, prohibitions on CEOs selling stock while on the job, and a ban on offshore tax havens.

### **Ratings agencies and proxy voting service companies**

A number of companies provide services in order to help companies and investors in digesting the already overwhelming amount of information that is provided on corporate governance. Information services such as Standard & Poor's (S&P) and BusinessWeek Online produce rankings, evaluations and research related to how and what companies disclose. These services are intended to assist investors in their work and help companies benchmark and communicate their internal governance practices to the public.

Another service provider, Institutional Shareholder Services (ISS), issues research and proxy voting recommendations and will take over an investor's entire proxy voting operation.<sup>27</sup> It also provides companies with a variety of governance advisory services. ISS maintains a database that assigns a Corporate Governance Quotient (CGQ) to companies. CGQ is a rating tool that assists institutional investors in evaluating the quality of corporate boards and the impact their governance practices may have on performance.

The Investor Responsibility Research Centre (IRRC) is an independent research firm that provides information on corporate governance and social responsibility issues affecting investors and corporations. IRRC has a stronger social and environmental focus than other advisers. Its founding can be traced to Viet Nam War era protests that triggered rules changes enabling shareholders to vote for the first time on shareholder proposals with social connotations.

S&P, Business Week Online, ISS, IRRC and other service and media organizations all rely on data that are derived primarily from company annual reports and standard regulatory filings. They fulfil an important role in translating raw data into actionable information and also illustrate the fundamental importance of public disclosure to the exercise of influence within the financial market.

### **Companies and industry groupings**

The first reaction of many companies to the Enron crisis was defensive. Many were slow to recognize the depth of the problem and questioned the need for legislation. While it seems that the business community, over time, has come to support the need for some regulation, if not legislation, it is widely believed that the writing of the SOA should have occurred with greater input from the companies.

Some of the most influential US business groupings such as the National Association of Corporate Directors (NACD) and the Business Roundtable (BRT), a grouping of CEOs of large companies, testified before Congress regarding the causes and impact of Enron, Congressional testimony by the BRT traditionally opposed to

regulation, and cautious about change, found Enron Corporation to be “a profound and troubling exception” in a system that has “generally worked very well”.<sup>28</sup> With the benefit of hindsight, it now appears that businesses underestimated the depth of the problem, the extent of public concern and the will of Congress to act.

Both the NACD and the BRT now express strong support for the broad-reaching reforms embodied by the Sarbanes-Oxley Act of 2002 and new exchange listing requirements. Both have underscored in their own recommendations the utmost necessity for improving corporate transparency. The NACD recently joined forces with CII to enhance corporate transparency, and the BRT has developed a body of best practice to assist companies in their efforts to improve governance. The Conference Board, a respected organization that is influential through its research and organization of conferences on themes of topical interest to executives, has conducted research into the area of governance and disclosure and remains an important voice supporting better governance in the business community.

Some companies stand out for the quality of their disclosure. According to a *Business Week* survey of the best and worst boards in the United States, Pfizer was second (while General Electric was ranked first) in overall approval by governance experts.<sup>29</sup> Pfizer is strong in substantive areas of governance such as the ability of independent directors to meet separately from the executive, and fully independent audit, nominating and compensation committees. Pfizer is also transparent. Along with copies of its financial statements and SEC filings, its website posts CEO/CFO certifications of financial statements, information on the board of directors, committee charters, copies of key governance policies and transactions of directors and executives in company stock.<sup>30</sup> Costs of stock option plans in terms of dilution and fair market value are shown in the financial statements.

Another company, Computer Associates, was considered until recently to have one of the worst boards because of weak oversight and excessive executive compensation. Sanjay Kumar, its Chairman and CEO, decided to transform the company into the “gold standard” of governance, and in 2002 the company found its way onto the *Business Week* list of most improved companies.

Implementing good governance at Computer Associates was not a question of a single dramatic event; it was, rather, a process. The company went through a number of phases. It added staff that were dedicated exclusively to enhancing its governance. The next phase was to develop principles of governance. Implementation of these principles required not only enhanced external communication but also, and more important, better internal communication and education to help employees understand the need for transparency. Computer Associates was, at the time of writing, moving into a final phase of continuous improvement.

Experience shows that requirements to disclose in “plain English” may be considerably more difficult to implement than one might anticipate. At Computer Associates, one of the most difficult aspects of bringing about better transparency has been to correctly communicate the company’s view of itself clearly to outsiders. Considerable effort was devoted to developing filings that meet this objective.

There are other examples of the company moving to implement best practice. Computer Associates’ website could now be considered a model with detailed and

comprehensive information on its governance.<sup>31</sup> Computer Associates will voluntarily expense its stock options beginning in April 2003.

A somewhat unusual example of improved disclosure is Fannie Mae. Fannie Mae was created by Congress in 1938 and was originally part of the Federal Housing Administration.<sup>32</sup> In 1968, Fannie Mae became a private company that bought mortgage obligations. Fannie Mae was criticized because of its historical exemption from registering and filing with the SEC. In response to the market's increased focus on governance and disclosure, Fannie Mae decided to voluntarily register its common stock and seek governance rating from Standard & Poor's. Its first filings are due in early 2003 and will correct the longstanding inconsistency in its disclosure obligations.

An increasing number of companies have been improving their disclosure practices by choosing to voluntarily disclose the true costs of their stock option plans in advance of legislative requirements. Before the passage of the SOA, only two companies on the S&P 500 index expensed stock options: Boeing, the aircraft manufacturer, and Winn-Dixie a department store chain.<sup>33</sup>

#### **D. The main implementation issues**

The SOA is a piece of domestic legislation with far-reaching international implications; it does not contain any exemption for foreign issuers. As a result, companies that register securities in the United States, whether directly or indirectly through ADRs, will need to comply with US rules regardless of whether their practices are legal in their country of origin. While the SOA does not apply to issuers exempt from US filing rules (Level 1 ADRs), stock exchanges will institute at least a "comply-or-explain" policy for their non-American listings. Foreign issuers on all three of the major US exchanges will need to disclose differences between their national governance practices and those specified by the exchange.

Some provisions of the SOA may not cause enormous problems for foreign companies: requirements for executive certification of financial statements exist in other countries and additional disclosures on board composition and codes of ethics can be developed. However, requirements to establish fully independent audit committees with new powers will inevitably conflict with the company law of many countries. Executives will be limited in their ability to take loans from companies and will own the risk of imprisonment and fines associated with the violation of the new rules.

Audit will also change. Foreign public accounting firms are subject to the requirements of the SOA when providing reports on issuers in the United States. Foreign audit firms will need to register with the newly established Public Company Accounting Oversight Board like their US counterparts. They will also need to adhere to the same rules regarding auditor independence and limitations on services that they may provide to audit clients. For all of these reasons, the Sarbanes-Oxley Act of 2002 is being closely scrutinized and, in some cases, harshly criticized in countries with developed and developing securities markets.

The US SEC has sought to respond to the concerns expressed in other countries. While it is not willing to budge on the substance of the SOA, the Commission recognizes that US rules may place foreign issuers in a difficult position: violate home country laws or comply with SEC rules. The SEC has made some accommodations where conflicts of law exist, including the following: where bodies similar to audit committees and independent of management exist, they may be accepted as audit committees; expanding the definition of an audit committee "financial expert" to include individuals who have expertise in generally accepted accounting principles in the home country of the issuer; and excluding foreign attorneys not licensed to practise law in the United States from coverage under SEC attorney conduct rules.<sup>34</sup>

Considerable effort has been made to give teeth to the new US governance and disclosure requirements by providing for tough enforcement and penalties, and additional resources have been provided to the SEC. However, resources alone will not make it more effective. Some outstanding questions are how the SEC will organize itself to meet its additional oversight responsibilities and how it can practically assure itself that the enormous amount of filings it receives are credible. Policy makers in other countries, who work with considerably less wherewithal, will be interested in knowing how the US brings its resources to bear.

In the accounting area, revenue recognition, accounting for SPEs and stock options seem to be leading concerns. Revenue and expense recognition underlie some of the accounting problems that ISAR sought to address in its past work on transfer pricing. A number of other issues remain on the horizon. One is dealing with the degree of complexity of a reporting system that simultaneously makes obfuscation easy and monitoring difficult. A longer-term issue is a more complete revamping of the accounting system. As KPMG Chairman Steven Butler put it; "Our accounting system doesn't do a good job of describing any modern company".<sup>35</sup>

The effectiveness and governance of FASB, the US accounting standard setter, will likely receive further attention. The mandatory rotation of audit firms will certainly become an issue once the final studies commissioned by the Sarbanes-Oxley Act of 2002 are completed. The United States has generally led in remuneration disclosure; however, there has been little real impact on the link between pay and financial performance, although a small number of companies are voluntarily disclosing the cost of stock options, which appears to be an important first step.

While leadership is clearly visible among some companies, boards remain far less independent (and transparent) than one might think, even when staffed by outsiders.<sup>36</sup> Transforming the good intentions of codes of conduct into corporate reality will require sustained effort, training and changing of entrenched attitudes not only among companies but also among financial service industry professionals. Questions concerning underlying business values seem to suggest that the topic of ethics could play a more prominent role in graduate school curricula.

**Appendix**

<b>Comparison of US Practice to ISAR Transparency and Disclosure Requirements for Corporate Governance*</b>	
<b>Text of ISAR Requirements</b>	<b>Comparison to US Practice</b>
<b>I. Financial disclosure</b>	
<p>1. <i>In particular, the group stressed the importance of disclosure of the company's financial and operating results, related-party transactions and critical accounting policies.</i></p>	<p>Listed companies are required to provide annual and quarterly financial statements prepared using US Generally Accepted Accounting Principles (US GAAP). US GAAP is a body of very detailed and complex standards that cover all aspects of financial and operating results and also require the disclosure of critical accounting policies. Pro forma statements are required to be prepared in accordance with US GAAP.</p>
<p>2. <i>The group agreed that enterprises should disclose all the financial information necessary for shareholders and other stakeholders to properly understand the nature of their business and how it was being developed for the future. In particular, any accounting policies to which the published results of the enterprise are especially sensitive should be disclosed, and the impact of alternative accounting decisions discussed.</i></p>	<p>Financial information disclosure has traditionally provided large amounts of information. However, complex accounting rules and business models can make a full understanding of the business difficult. Recently, more attention has been devoted to a fuller discussion of accounting policies at the level of the board of directors, and to a fuller discussion between the auditor and the board on the impact of alternative policies. The impact of alternative accounting decisions may not necessarily be discussed in statements.</p>
<p>3. <i>The group recognized that enterprises should disclose all related-party transactions and in addition any related-party relationships where control exists. At a minimum, disclosure should be made of the nature, type and elements of the related-party transactions. Even</i></p>	<p>Related-party transactions need to be disclosed under the Securities Act of 1934, however, rules may permit non-disclosure if the transaction is not deemed material or because relationships where control exist do not meet specified thresholds.</p>

\* The details contained in this comparative table were compiled by a consultant on a preliminary basis. They are also subject to change due to possible developments subsequent to the study.

<p><i>related-party relationships where control exists, irrespective of whether there have been transactions with parties under common control, should be disclosed. The decision-making process for approving related-parties transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company.</i></p>	<p>Section 403 of the Sarbanes-Oxley Act of 2002 seeks to tighten related party disclosure. The SOA also requires fuller review of related-party transactions by board audit committees. These disclosures must now be filed in close to real time on the SEC internet site and the web site of the issuer.</p>
<p>4. <i>Critical accounting policies that are key to the portrayal of an enterprise's financial condition and operating results should be disclosed.</i></p>	<p>Critical accounting policies must be disclosed according to US GAAP in the company's financial statements. New SEC rules require that auditors fully describe impact of alternative policies to audit committees who are to review and approve them.</p>
<b>II. Non-Financial Disclosures</b>	
<b>A. Company Objectives</b>	
<p>5. <i>The ad hoc consultative group agreed that the objectives of the enterprise should be disclosed.</i></p>	<p>The objectives of the enterprise are disclosed in SEC filings. Should significant changes occur in the objectives of the enterprise, additional filings need to be made. Most companies include a discussion of objectives and strategy in their annual reports and are likely to discuss objectives more frequently at analyst meetings.</p>
<b>B. Ownership and Shareholders' Rights</b>	
<p>6. <i>The ad hoc group recognized that the ownership structure should be fully disclosed to all shareholders. It was also recognized that changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company became aware of them.</i></p>	<p>The full ownership structure of the enterprise may not be known to management due to the highly fragmented ownership structure of most publicly traded US companies. However, disclosures are required if shareholders cross certain thresholds of ownership. The obligation to divulge ownership may reside with the shareholder and not the company.</p>

<p>7. <i>The group took a view that disclosure should be made of control structures and of how shareholders or other members of the organization can exercise their control rights through voting or other means. It also discussed that any arrangement under which some shareholders may have a degree of control disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed.</i></p>	<p>The control structure of enterprises is generally well disclosed. It is determined primarily by company law in the state of incorporation. In addition, the company charter and internal by-laws may contain further details on how control is exercised within the organization. Finally, securities law requires disclosure of ownership structures that confer special rights. While the control structure of the overall company may be publicly disclosed, the use of Special Purpose Entities may effectively obscure how certain corporate assets are controlled.</p>
<p>8. <i>The group agreed that rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.</i></p>	<p>Rules and procedures governing acquisitions and corporate control are found in legislation and regulation and listing requirements. These rules cover procedures for sales of substantial portions of company assets and other extraordinary transactions. There is no obligation for companies themselves to compile or disclose these rules though transactions themselves may be subject to shareholder approval.</p>
<p><b>C. Governance Structures and Policies</b></p>	
<p><b>The structure, role and functions of the board</b></p>	
<p>9. <i>The group took the view that the composition of the board should be disclosed, in particular the balance of executives and non-executive directors. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues are not significant and do not impinge on the independence of the directors.</i></p>	<p>Under new rules, the composition of the board will become more transparent. Stock exchange listing requirements will require disclosure on factors impinging director independence.</p>
<p>10. <i>The group took the view that board's role and functions must be fully disclosed.</i></p>	<p>Board and committee functions will become significantly more detailed as a result of new legislation, regulation and listing requirements.</p>

<b>Board committees</b>	
<i>11. The ad hoc consultative group suggested that such governance structures be disclosed. In particular, the group agreed that the board should disclose structures put in place to prevent conflicts between the interests of the directors and management on the one side and those of shareholders and other stakeholders on the other.</i>	As a result of new listing requirements, boards must now disclose significant new information on independence, board composition, performance evaluation, access to management, orientation and training and other issues. The purpose of this disclosure is to allow the public to assess the independence and effectiveness of board members. As such, it should also allow for an evaluation of potential conflicts of interest with stakeholders.
<i>12. It was also agreed that the composition and functions of any such groups or committees should be fully disclosed. Where any director has taken on a specific role for the board or within one of these structures, this should be disclosed.</i>	Key board committees are subject to disclosure though most disclosure requirements focus on audit committees. Disclosure of certain key aspects of the committee's function such as, for example, the name of the "financial expert" as well as his/her background are now mandatory. Depending upon the exchange, listing rules may require disclosure of the identity of special roles (such as that of chairperson) of directors during meetings.
<b>D. Members of the Board and Key Executives</b>	
<b>1. Duties and qualifications</b>	
<i>13. The group recommended that the duties of individual directors be disclosed. It was agreed that the number of directorships held by an individual director should be disclosed.</i>	Companies listed on the NYSE would need to disclose full information on directors including duties. The number of directorships may not be disclosed. If a director on an audit committee sits on more than three other company committees, his ability to fulfil his duties must be certified.
<i>14. The experts took the view that there should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfil their responsibilities.</i>	Disclosure of qualifications and biographical information is required under NYSE listing requirements though information on the level of detail of such information is not available.

<p><i>There should also be disclosure of the mechanisms which are in place to act as “checks and balances” on key individuals in the enterprise.</i></p>	<p>Specific disclosure under the rubric of “checks and balances” is not required, however, peripheral information, such as for example, the number of independent directors on the board, or the requirement that auditors report directly to an independent audit committee, may help in ascertaining the checks and balances on management.</p>
<p>15. <i>There should be disclosure of the types of development and training that directors undergo at induction and on an ongoing basis (continuing education).</i></p>	<p>The NYSE requires such disclosure.</p>
<p>16. <i>Therefore, the group suggested that the board disclose facilities, which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the year in question.</i></p>	<p>Legislation, regulation and listing requirements require access to outside advice. There is, however, no requirement for disclosure that outside advice has been sought.</p>
<p><b><i>Evaluation mechanism</i></b></p>	
<p>17. <i>The ad hoc group agreed that the board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the valuation are being used.</i></p>	<p>Annual performance evaluations must be disclosed according to NYSE listing requirements. No specific mention is made of disclosing the evaluation methodology or how the evaluation will be used.</p>
<p><b><i>Directors’ remuneration</i></b></p>	
<p>18. <i>The ad hoc consultative group took the view that directors should disclose a transparent and accountable mechanism for setting directors’ remuneration. Disclosure should be as full as possible to demonstrate to shareholders and other stakeholders that pay is tied to the company’s long-term performance as measured by recognized criteria. Information regarding pay packages should include salary, share options and other associated benefits, financial or otherwise, as well as reimbursed</i></p>	<p>Efforts are being made to improve the function of remuneration committees, and increase their transparency. Disclosure of cash, bonus, benefits and stock remuneration is required for certain executives in all publicly traded companies. Reimbursed expenses may be reported if they are significant.</p> <p>Information on the manner in which remuneration is linked to individual and company performance is variable in quality with the relationship being, in some cases, tenuous. Disclosure of the</p>

<p><i>expenses. Where share options are used as incentives but are not treated as expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.</i></p>	<p>cost of options according to an accepted option pricing model is not generally done though some companies are doing so voluntarily in response to recent criticism. Broader disclosure in financial statements will depend upon the development of new accounting standards for stock options.</p> <p>Stock compensation plans will, however, be subject to shareholder approval, and a broadly accepted approach to disclosing the cost of these plans will likely emerge.</p>
<p><i>19. The group discussed that the length of directors' contracts as well as the nature of compensation payable to any director for cancellation of service contract should be disclosed. Specific reference could be made to any special arrangement that might relate to severance payments to directors in the event of a takeover.</i></p>	<p>Information could not be found on the legal obligation to disclose compensation in the event of cancellation of a director service contract nor in the event of a takeover.</p> <p>Information on "golden parachutes" is, however, generally available for top executives in proxy statements.</p>
<b>Succession planning</b>	
<p><i>20. The group took the view that the board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for sustaining the business. It also recognized that there might be confidentiality issues and that the details of any individual plan should not necessarily be publicly disclosed.</i></p>	<p>NYSE listing rules require disclosure of certain succession issues.</p>
<b>Conflict of interest</b>	
<p><i>21. The group suggested that conflicts of interests affecting members of the board should, if they were not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.</i></p>	<p>To the extent that conflicts of interest either impinge independence or could result from related party transactions, conflicts of interest would be disclosed. The NYSE specifies procedures for verification of independence though there is no specific mention of a "hierarchy of obligations".</p>

<b>E. Material Issues Regarding Employees and Other Stakeholders</b>	
22. <i>The group recommended disclosure of whether there was a mechanism protecting the rights of other stakeholders in a business.</i>	No such disclosure appears to be required.
<b>F. Environmental and Social Stewardship</b>	
23. <i>The group took the view that the board should disclose its policy and performance in connection with environmental and social responsibility and the impact of this policy and performance on the firm's sustainability.</i>	<p>Sustainability reporting is not required by law. However, any factors materially impacting a company's performance (including social and environmental factors such as, for example, an impending labour action, or costs of an environmental cleanup) need to be disclosed according to US GAAP and by law.</p> <p>Many companies report voluntarily on social and environmental issues, and boards are increasingly aware of its importance. However, standards for reporting and auditing are still in early stages of development compared with financial reporting. The quality of such statements is thus not likely to have the same level as financial statements.</p> <p>The source of environmental and social reporting is most often the company and not the board of directors as suggested in the ISAR requirements.</p>
<b>G. Material Foreseeable Risk Factors</b>	
24. <i>The group took the view that the board should give appropriate disclosures and assurance regarding its risk management objectives, systems and activities. In particular, it was agreed that the board should disclose existing provisions for mitigating the possible negative effects of risk-bearing activities. The board should report on internal control systems and their effectiveness.</i>	<p>Material foreseeable risk factors are filed as part of the initial public offering process. Certain risk factors must be disclosed in the financial statements according to US GAAP if there is a reasonable presumption they could occur.</p> <p>The audit committee is responsible for reviewing risks with the auditor and also assuring that there are appropriate systems for risk management. Management is responsible for reporting that appropriate internal</p>

	control systems are in place. The extent to which the board is responsible for disclosing mitigating negative effects of risk-bearing activities could not be ascertained.
<b>H. Independence of Auditors</b>	
25. <i>The group agreed that the board should disclose that it had confidence that the auditors are independent and their integrity had not been compromised in any way. The process for interaction with and appointment of internal and external auditors should be disclosed.</i>	<p>Recent legislation focuses to a large extent on measures to increase auditor independence and to make the auditor increasingly responsible to the board as a representative of shareholders, rather than management. The board must fulfil certain responsibilities to help ensure auditor independence such as, for example, the approval of all non-audit services rendered the auditor.</p> <p>However, an assessment of current rules would not appear to specifically require that the board disclose that it has confidence in the independence of the auditor, that the auditor's independence is uncompromised or the process for interacting with the internal and external auditors.</p>
<b>III. Annual General Meetings</b>	
26. <i>The group discussed the need for disclosure of the process for holding annual general meetings. Notification of the agenda should be made in a timely fashion, and the agenda should be made available in the national language (or one of the official languages) of the enterprise and, if appropriate, an internationally used business language.</i>	The organization of AGMs is subject to rules regarding notification, mailing of the agenda, and other procedural details. While there may be dissatisfaction among some regarding the utility of AGMs, timing of notification and the availability of the agenda do not appear to be a concern.

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## Summary of the Key Provisions of the Sarbanes-Oxley Act of 2002<sup>37</sup>

### **Public Company Accounting Oversight Board**

The Act establishes that a Public Company Accounting Oversight Board will be appointed within ninety days that will: (1) register public accounting firms that prepare audit reports; (2) oversee the audit of public companies that are subject to the securities laws; (3) establish audit report standards and rules; and (4) investigate, inspect, and enforce compliance relating to registered public accounting firms and the obligations and liabilities of accountants. The ongoing mission of the Board is to promote high professional standards on the part of public accounting firms and to improve the quality of the audit services that such companies offer.

#### **Membership**

The Board will comprise five members who have demonstrated commitment to the interests of investors and the public, as well as both an understanding of the financial disclosures of public companies and the obligations of their auditors. Only two members of the Board can be or can have been CPAs, provided that if one of these two members is the chairperson, the chairperson may not have been in practice for at least five years prior to his or her appointment.

#### **Disciplinary Sanctions**

The Act empowers the Board to impose disciplinary or remedial sanctions upon registered public accounting firms that are in violation of the Act, including the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect to them. Liability is restricted to intentional conduct, or repeated instances of negligent conduct. The Board is also authorized to sanction a registered accounting firm or its supervisory personnel for failure to supervise.

#### **Foreign Public Accounting Firms**

Foreign public accounting firms that prepare or furnish an audit report with respect to any issuer are also deemed to be subject to the oversight of the Board, with the proviso that registration with the Board by a foreign firm will not in itself provide a basis for subjecting the firm to the jurisdiction of Federal or State courts. The Board may determine that even though a foreign public accounting firm doesn't issue audit reports that it participates to such an extent in their preparation that it is necessary for the firm to register with and be overseen by the Board.

#### **Oversight of the Board**

The SEC will have general oversight of and authority over the Board and the power to review Board actions, including general modification and rescission of Board authority. In particular, the SEC will review and approve any rule proposed by the Board before its adoption.

## **Auditor Independence**

The Sarbanes-Oxley Act amends the Securities Exchange Act of 1934 to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with a mandatory audit.

These prohibited activities include:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker-dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the Board determines, by regulation, is impermissible.

Pre-approval for non-audit services not expressly forbidden by statute is required. The Act further mandates that an audit firm cannot provide audit services to an issuer if the lead or coordinating audit partner who has primary responsibility for the audit or if the audit partner responsible for reviewing the audit has performed audit services for the issuer in each of the five previous fiscal years.

Audit firms must report to the audit committee of the issuer and describe all critical accounting policies. In addition, registered public accounting firms are prohibited from performing statutorily mandated audit services for an issuer if the issuer's senior management officials had been employed by such firm and participated in the audit of that issuer during the one-year period preceding the audit initiation date.

It is the intention of the Act that, in supervising non-registered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise.

## **Corporate Responsibility**

### **Audit Committees**

The Act vests the audit committee of a public company with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. Committee members are required to be a member of the board of directors of the company, and to be otherwise independent.

### **Financial Statement Certification**

The chief executive officer and chief financial officer of an issuer are required to certify that periodic financial statements filed with the SEC fairly present, in all material respects, the operations and financial condition of the issuer. This rule takes effect 30 days after the Act's enactment.

### **Insider Trading**

No director or executive officer of an issuer can execute such trades during pension fund blackout periods. Any profits realized by such trades shall be recoverable by the issuer.

### **Enhanced Financial Disclosures**

Not later than 180 days after enactment, the SEC must require disclosure of all material off-balance sheet transactions and relationships that may have a material effect upon the financial status of an issuer.

### **Rules Regarding Pro Forma Financial Information**

Also within 180 days the Commission shall issue final rules requiring that: (1) pro forma financial information included in reports filed with Commission or in any public disclosure shall be presented (1) in a manner that doesn't contain any untrue statement of material fact or omission of material facts necessary to a fair and accurate representation that isn't misleading, and (2) that is reconciled to generally accepted accounting principles.

### **Off-Balance-Sheet Transactions and Special-Purpose Entity Study**

The SEC is directed to study and report to Congress on: (1) the extent of off-balance sheet transactions and the use of special purpose entities; and (2) whether generally accepted accounting rules result in financial statements that reflect the economics of such off-balance sheet transactions in a transparent fashion to investors; and (3) the extent to which special purpose entities are used to facilitate off-balance sheet transactions.

### **Enhanced Conflict of Interest Provisions**

Corporations are prohibited from making personal loans to their corporate directors and executive officers, with some exceptions for home improvement and manufactured home loans made in the ordinary course of the consumer credit business of such issuer and made on terms that are no more favourable than those offered to the general public.

### **Disclosures of Transactions Involving Management and Principal Stockholders**

Effective 30 days after the signing of the Act, the mandatory period for principal stockholders or senior executives to disclose changes in ownership of securities or security-based swap agreements will be reduced to two business days after changes are executed (presently ten days after the close of a calendar month).

### **Management Assessment of Internal Controls**

The SEC is mandated to prescribe rules mandating inclusion of an internal control report and assessment within requisite annual reports. In addition, the public accounting firm that prepares or issues the audit report for the issuer must attest to, and report on, the assessment made by corporate management.

### **Code of Ethics for Senior Financial Officers**

The SEC is directed to issue rules requiring a code of ethics for senior financial officers of an issuer applicable to the principal financial officer, comptroller or principal accounting officer or persons performing similar functions.

The Commission is also directed to revise its regulations concerning matters requiring prompt disclosure on Form 8-K requiring immediate disclosure by any issuer of any change or waiver of the code of ethics for senior financial officers.

### **Disclosure of Audit Committee Financial Expert**

The Act sets a 90-day deadline for the SEC to promulgate rules that require issuer disclosure as to whether its audit committee comprises at least one member who is a financial expert. The Commission is directed to consider, in defining the term “financial expert” whether a person has, through education or experience, as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, and understanding of generally accepted accounting principles and experience in:

- the preparation or auditing of financial statements of generally comparable issuers
- the application of generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves, and experience with internal accounting controls
- an understanding of the audit committee function

### **Analyst Conflicts Of Interest**

#### **Securities Analysts and Research Reports**

The Act requires the SEC to adopt rules governing securities analysts’ potential conflicts of interest, including:

- (1) Restricting the prepublication clearance or approval of research reports by persons either engaged in investment banking activities, or not directly responsible for investment research;

- (2) Limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities;
- (3) Prohibiting a broker or dealer involved with investment banking activities from retaliating against a securities analyst as a result of an unfavourable research report that may adversely affect the investment banking relationship of the broker or dealer with the subject of the research report; and
- (4) Establishing safeguards to assure that securities analysts are separated within the investment firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

### **Commission Resources And Authority**

#### **Appropriations are authorized for fiscal year 2003 to the SEC for:**

- additional compensation, salaries and benefits;
- enhanced oversight of auditors and audit services; and
- additional professional staff for fraud prevention, risk management, market regulation, and investment management.
- The SEC is granted censure authority in connection with appearance and practice before the Commission. The Act sets forth rules of professional responsibility for attorneys representing public companies before the SEC, including:
  - requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal counsel or the chief executive officer of the company; and
  - if corporate executives do not respond appropriately, requiring the attorney to report to the audit committee of the board of directors.

### **Corporate And Criminal Fraud Accountability**

#### **Destruction, Alteration, or Falsification of Records**

The Act amends Federal criminal law to prohibit: (1) knowingly destroying, altering, concealing, or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy; and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities. The Act also directs the SEC to promulgate regulations regarding the retention of audit records containing conclusions, opinions, analyses, or financial data.

#### **Non-dischargeable Debts**

Federal bankruptcy law is amended to make non-dischargeable in bankruptcy certain debts that result from a violation relating to Federal or State securities law, or of common law fraud pertaining to securities sales or purchases.

### **Statute of Limitations**

The Federal judicial code to permit a private right of action for a securities-fraud claim to be brought not later than the earlier of: (1) five years after the date of the alleged violation; or (2) two years after its discovery.

### **Review of Federal Sentencing Guidelines**

The Act directs the United States Sentencing Commission to review and amend Federal sentencing guidelines to ensure that the offence levels, existing enhancements, and/or offence characteristics are sufficient to deter and punish violations involving: (1) obstruction of justice; (2) destruction of records; (3) fraud when the number of victims adversely involved is significantly greater than 50 or when it endangers the solvency or financial security of a substantial number of victims; and (4) organizational criminal misconduct.

### **Protection for Public Company Employees**

Publicly traded company are prohibited from discharging or otherwise discriminating against an employee because of any lawful act by the employee to: (1) assist in an investigation of prohibited conduct by Federal regulators, Congress, or supervisors; or (2) file or participate in a proceeding relating to fraud against shareholders.

The Act delineates remedies for such aggrieved employee, including reinstatement, back pay, and compensatory damages.

### **White-Collar Crime Penalty Enhancements**

The Sarbanes-Oxley Act creates the “White-Collar Crime Penalty Enhancement Act of 2002,” which directs that:

Federal criminal law is to be amended to increase criminal penalties for: (1) conspiracy to commit offence or to defraud the United States, including its agencies; and (2) mail and wire fraud. In addition, the Employee Retirement Income Security Act of 1974 is amended to increase the criminal penalties for violations of such Act.

The United States Sentencing Commission to review Federal Sentencing Guidelines to: (1) ensure that they reflect the serious nature of the offences and the penalties set forth in this Act, the growing incidence of serious fraud offences, and the need to deter and punish such offences; and (2) consider whether a specific offence characteristic should be added in order to provide stronger penalties for fraud committed by a corporate officer or director.

Federal criminal law shall be amended to require senior corporate officers to certify in writing that financial statements and the disclosures therein fairly present in all material aspects the operations and financial condition of the issuer.

Any person who recklessly and knowingly violates such requirement shall be subject to criminal liability, including maximum imprisonment of: (1) ten years for wilful violation; and (2) five years for reckless and knowing violation.

### **Corporate Fraud Accountability**

The Sarbanes-Oxley Act creates the Corporate Fraud Accountability Act of 2002, which directs that:

Anyone who corruptly tampers with a record with intent to impair the object's integrity or availability for use in an official proceeding, or otherwise impedes an official proceeding, will be subject to a maximum ten-year prison term.

The Securities Exchange Act of 1934 shall be amended to authorize the SEC to seek a temporary injunction to freeze extraordinary payments earmarked for designated persons or corporate staff under investigation for possible violations of Federal securities laws.

The United States Sentencing Commission be requested to: (1) promptly review sentencing guidelines applicable to securities and accounting fraud; and (2) expeditiously consider promulgation of new sentencing guidelines to provide an enhancement for senior corporate officers who commit fraud and related offences. Guidelines are to be prescribed for Commission consideration, including a request that it ensure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offences.

## Notes

<sup>1</sup> As per Mr. Harvey Pitt, in his response letter to the Senate Committee on Governmental Affairs, dated 4 March 2002.

<sup>2</sup> MSCI Red Book, Month End May 2003.

<sup>3</sup> United States General Accounting Office, "Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate".

<sup>4</sup> The full text of the Sarbanes-Oxley Act of 2002 is available on the website of the United States Government Printing Office: [www.access.gpo.gov](http://www.access.gpo.gov). The table of contents of the SOA and a detailed summary are included in the appendix. For a summary that also includes a discussion of SEC Final Rules developed in response to SOA, see "Navigating the Sarbanes-Oxley Act of 2002", PriceWaterhouseCoopers at [www.pwcglobal.com](http://www.pwcglobal.com).

<sup>5</sup> A number of these studies were completed or close to completion at the time of writing of the report. For more information, see below and Appendix.

<sup>6</sup> A more detailed summary of the main conclusions of the four studies available at the time of writing can be found in the appendix. For full copies of the studies conducted by the Government Accounting Office (GAO), including "Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges", consult the website [www.gao.gov](http://www.gao.gov). For studies conducted by the US SEC consult [www.sec.gov](http://www.sec.gov). For "An Analysis of Restatement Matters: Rules, Errors, Ethics" see [www.huronconsultinggroup.com](http://www.huronconsultinggroup.com).

<sup>7</sup> For general information on the US SEC consult [www.sec.gov/](http://www.sec.gov/).

<sup>8</sup> Section 601 of the Sarbanes-Oxley Act of 2002 provides for further appropriations for the SEC.

<sup>9</sup> "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs", Report of the Senate Committee on Governmental Affairs, 8 October 2002.

<sup>10</sup> For the full text of the Final Rules, consult the US SEC website at [www.sec.gov/rules/final.shtml](http://www.sec.gov/rules/final.shtml).

<sup>11</sup> For the full text of Regulation FD see the SEC website: [www.sec.gov](http://www.sec.gov).

<sup>12</sup> The American Institute of Investment Management and Research (AIMR) and the Securities Industry Association (SIA).

<sup>13</sup> For further information on these actions see the SEC website for the following releases: Motorola, Inc., Release No. 46898; Siebel Systems, Inc., Release No. 46896, Lit. Release No. 17860; Secure Computing Corporation, Release No. 46895; Raytheon Company, Release No. 46897.

<sup>14</sup> Individual states also regulate financial markets in the United States. In particular, the state of New York, home of the major US exchanges (American, NASDAQ and the New York Stock Exchange) has regulation in addition to federal regulation. The role of the states in regulating financial markets has not been considered in the preparation of this study. Concerns regarding duplication of efforts and potentially contradictory goals and outcomes of federal and state laws could be the topic of a separate case study.

<sup>15</sup> Testimony of Robert K. Herdman, Chief Accountant, U.S. Securities and Exchange Commission, before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, of the U.S. House of Representatives on 14 February 2002.

<sup>16</sup> Recommendations from The National Association Of Corporate Directors, Concerning Reforms in the Aftermath of the Enron Bankruptcy. Updated Version of 3 May 2002: [http://www.nacdonline.org/nacd/enron\\_recommendations.asp](http://www.nacdonline.org/nacd/enron_recommendations.asp).

<sup>17</sup> "The Holes in GAAP", 01/17/2002, *Financial Times*.

<sup>18</sup> GAAP 2001, A Survey of National Accounting Rules Benchmarked Against IFRS.

<sup>19</sup> GAAP Convergence 2002, A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards.

<sup>20</sup> For the full texts of these proposals see the exchange websites: AMEX: [www.amex.com](http://www.amex.com); NASDAQ: [www.nasdaq.com](http://www.nasdaq.com); NYSE: [www.nyse.com](http://www.nyse.com).

<sup>21</sup> For a comparison of all of the major elements of the exchange proposals including relevant elements of the Sarbanes-Oxley Act and final SEC rules as of 7 February 2003, see the "Assessment Guide for US Legislative, Regulatory and Listing Requirements", Institute of Internal Auditors Research Foundation.

<sup>22</sup> In an odd twist of fate CalPERS played a role in helping Enron keep debt off of its balance sheet through an SPE called the Joint Energy Development Investors (JEDI). It is also ironic that Enron executives could eventually be accused of manipulating energy markets and causing a severe energy crisis in the state of California.

<sup>23</sup>For more information on CalPERS, including its Principles of Corporate Governance and its plan for corporate and legislative reform, see: [www.calpers-governance.org/](http://www.calpers-governance.org/).

<sup>24</sup>For the full text of CII Core Policies and the General Principles, see: [www.cii.org/corp\\_governance.asp](http://www.cii.org/corp_governance.asp)

<sup>25</sup><http://www.ici.org/>

<sup>26</sup><http://www.tiaa-cref.org/libra/governance/index.html>.

<sup>27</sup>[www.issproxy.com](http://www.issproxy.com)

<sup>28</sup>Business Roundtable Corporate Governance Task Force Chairman, Franklin Raines, before House Panel.

<sup>29</sup>*Business Week*, 7 October 2002.

<sup>30</sup>The Pfizer website can be found at: [www.pfizer.com/are/mn\\_investors\\_corporate.cfm](http://www.pfizer.com/are/mn_investors_corporate.cfm).

<sup>31</sup>The Computer Associates governance website can be found:

[www.computerassociates.com/governance](http://www.computerassociates.com/governance).

<sup>32</sup>More information on Fannie Mae can be found at: [www.fanniemae.com/index.jhtml](http://www.fanniemae.com/index.jhtml).

<sup>33</sup>Since then, more and more companies have decided to voluntarily disclose the cost of option compensation plans, Mathew Ingram, "Expensing options is a bandwagon worth joining," *The Globe and Mail*, 16 August 2002.

<sup>34</sup>For a full list of the accommodations cited in a 11 June 2003 speech by Roel C. Campos, SEC Commissioner, see the appendix.

<sup>35</sup>Jeffrey E. Garten, "Corporate Standards: Raise the Bar Around the World", *Newsweek*, 13 May 2002.

<sup>36</sup>One only need look to Enron for what was broadly considered a model board. *Chief Executive Magazine* rated the Enron Board among the top five in the United States in 2000. Enron was also found to be one of the most admired US companies in innovation, employee talent and quality of management by *Fortune* in February 2000.

<sup>37</sup>Reproduced with permission of Clark, Schaefer, Hackett & Co.: <http://www.cshco.com>.



<b>Title</b>	<a href="#"><u>Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges</u></a>	<a href="#"><u>An Analysis of Restatement Matters: Rules, Errors, Ethics, For the Five years ended December 31, 2002.</u></a>	<b>Report of the SEC: Section 703 of the Sarbanes Oxley Act of 2002: Study and Report on Violations by Securities Professionals</b>	<a href="#"><u>Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002</u></a>
<b>Source</b>	<a href="#"><u>General Accounting Office</u></a>	<a href="#"><u>Huron Consulting Group</u></a>	US SEC	US SEC
<b>Major conclusions</b>	<p>The number of accounting failures have increased 145%</p> <p>The proportion of NYSE and listed companies restating as a percentage of the total tripled</p> <p>Revenue recognition was the primary reason for a restatement, comprising 38% of the total</p> <p>Average stock price decreased almost 10% on the day following the announcement with larger losses 60 days following</p> <p>Losses had ripple effects on investor confidence and market trends</p> <p>Restatements seem to have shaken faith in the financial system and raised questions about integrity of US markets</p> <p>Restatements cast doubt upon system of governance and disclosure oversight</p>	<p>Restatements are increasing dramatically and are up 22% from the prior year</p> <p>The number of big companies restating increased 90% from 2001 to 2002</p> <p>Revenue recognition is the primary reason for a restatement followed by restatements due to: improper reserves, accruals, and contingencies; improper equity accounting; acquisition accounting and capitalization; and expensing of assets</p>	<p>During the 4-year period of the study, 1,596 securities professionals violated securities laws</p> <p>The most common type of SEC action was against broker-dealer related individuals involving fraud against customers</p> <p>A large variety of other violations occurred by a spectrum of securities professionals</p>	<p>Many areas of financial reporting are susceptible to fraud and manipulation</p> <p>The majority of enforcement matters relate to revenue and expense recognition, though a wide variety of other issues are covered</p> <p>Auditor violations often arise from accepting management representations without verification, improper analytical and substantive procedures, and failing to gain sufficient evidence</p> <p>The Commission recommends focusing on: 1) uniform reporting of restatements, and; 2) improved MD&amp;A disclosure. Other recommendations are made</p>

Summary of Final Rules of SEC Implementing the Sarbanes-Oxley Act of 2002

33-8124	Aug. 29, 2002	Certification of Disclosure in Companies' Quarterly and Annual Reports
<p><b>Summary:</b> In accordance with Section 302(a) of the Sarbanes-Oxley Act of 2002, these rules require an issuer's principal executive and financial officers each to certify the financial and other information contained in the issuer's quarterly and annual reports. The rules also require these officers to certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.</p> <p>In addition, the rules require issuers to maintain and regularly evaluate the effectiveness of disclosure controls and procedures designed to ensure that the information required in reports is recorded, processed, summarized and reported on a timely basis. <i>Effective Date:</i> August 29, 2002.</p>		
33-8128	Sept. 5, 2002	Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports
<p><b>Summary:</b> These rules accelerate the filing of quarterly and annual reports under the Securities Exchange Act of 1934 by domestic reporting companies that have a public float of at least \$75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report. The changes for these accelerated filers will be phased-in over three years. The annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. Amendments require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the SEC.</p>		
34-47225	Jan. 22, 2003	Insider Trades During Pension Fund Blackout Periods
<p><b>Summary:</b> This rules clarifies the application and prevents evasion of Section 306(a) of the Sarbanes-Oxley Act of 2002. Section 306(a) prohibits any director or executive officer of an issuer of any equity security from, directly or indirectly, purchasing, selling or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants or beneficiaries from engaging in equity securities transactions through their plan accounts, if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer.</p> <p>The rules are designed to facilitate compliance with the will of Congress as reflected in Section 306(a) to eliminate the inequities that may result when pension plan participants and beneficiaries are temporarily prevented from engaging in equity securities transactions through their plan accounts. <i>Effective Date:</i> January 26, 2003.</p>		
33-8176	Jan. 22, 2003	Conditions for Use of Non-GAAP Financial Measures

<p><b>Summary:</b> As directed by the Sarbanes-Oxley Act of 2002, the SEC adopted new rules and amendments to address public companies' disclosure or release of certain financial information that is calculated and presented on the basis of methodologies other than US GAAP. Regulation G requires public companies that disclose or release non-US GAAP financial measures to include in that disclosure or release a presentation of the most directly comparable US GAAP financial measure and reconciliation to the most directly comparable US GAAP financial measure. Effective Date: March 28, 2003.</p>		
33-8177	Jan. 23, 2003	Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002
<p><b>Summary:</b> This rule requires companies, other than registered investment companies, to include two new types of disclosures in their annual reports filed pursuant to the Securities Exchange Act of 1934.</p> <p>First, the rules require a company to disclose whether it has at least one “audit committee financial expert” serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert.</p> <p>Second, the rules require a company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. A company disclosing that it has not adopted such a code must disclose this fact and explain why it has not done so. A company will also be required to promptly disclose amendments to, and waivers from, the code of ethics relating to any of those officers. Effective Date: March 3, 2003.</p>		

33-8180	Jan. 24, 2003	Retention of Records Relevant to Audits and Reviews
<p><b>Summary:</b> The rule requires accounting firms to retain certain records relevant to their audits and reviews of issuers' financial statements for seven years. Records to be retained include an accounting firm's work papers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review. Effective Date: March 3, 2003.</p>		
34-47262	Jan. 27, 2003	Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002
<p><b>Summary:</b> This rule requires that registered management investment companies file certified certain reports with the Commission and make new disclosures in order to implement the requirements of Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.</p> <p>The rules require a company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer and senior financial officers. A company disclosing that it has not adopted such a code must explain why it has not done so. A company will also be required to disclose amendments to, and waivers from, the code of ethics relating to any of those officers. The rules require a company to disclose whether it has at least one "audit committee financial expert" serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert.</p> <p>The amendments require each registered management investment company's principal executive and financial officers to certify the information contained in these reports in the manner specified by Section 302 of the Sarbanes-Oxley Act of 2002. <i>Effective Date:</i> March 1, 2003</p>		
3-8182	Jan. 27, 2003	Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations
<p><b>Summary:</b> As directed by new Section 13(j) of the Securities Exchange Act of 1934, added by Section 401(a) of the Sarbanes-Oxley Act of 2002, the SEC has adopted amendments to rules to require disclosure of off-balance sheet arrangements. The amendments require a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" (MD&amp;A) section of a registrant's disclosure documents. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format.</p>		

33-8183	Jan. 28, 2003	Strengthening the Commission's Requirements Regarding Auditor Independence
<p><b>Summary:</b> The SEC has adopted amendments to existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. The final rules recognize the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence.</p> <p>Consistent with the direction of Section 208(a) of the Sarbanes-Oxley Act of 2002, the SEC has adopted rules to: revise the Commission's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence; require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements; prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement; prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements. In addition, under the final rules, an accountant would not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services. These rules affect foreign accounting firms that conduct audits of foreign subsidiaries and affiliates of U.S. issuers, as well as of foreign private issuers. Dates: Effective Date: May 6, 2003.</p>		

33-8185	Jan. 29, 2003	Implementation of Standards of Professional Conduct for Attorneys
<p><b>Summary:</b> This final rule establishes standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers. Section 307 of the Sarbanes-Oxley Act of 2002 requires the Commission to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. The standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the company to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors. Proposed Part 205 responds to this directive and is intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct.</p>		
33-8188	Jan. 31, 2003	Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies
<p><b>Summary:</b> The Securities and Exchange Commission is adopting rule and form amendments under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to require registered management investment companies to provide disclosure about how they vote proxies relating to portfolio securities they hold. These amendments require registered management investment companies to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities. The amendments also require registered management investment companies to file with the Commission and to make available to shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities. Effective Date: April 14, 2003.</p>		
IA-2106	Jan. 31, 2003	Proxy Voting by Investment Advisers
<p><b>Summary:</b> The Commission is adopting a new rule and rule amendments under the Investment Advisers Act of 1940 that address an investment adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. The new rule requires an investment adviser that exercises voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies. The rule amendments also require advisers to maintain certain records relating to proxy voting. The rule and rule amendments are designed to ensure that advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted. Dates: Effective Date: March 10, 2003.</p>		

33-8193	Feb. 20, 2003	Regulation Analyst Certification
<b>Summary:</b> Regulation AC requires that brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views. Broker-dealers would also be required to obtain periodic certifications by research analysts in connection with the analyst's public appearances. By requiring these certifications and disclosures, Regulation AC should promote the integrity of research reports and investor confidence in those reports. Effective Date: April 14, 2003.		
33-8183A	Mar. 26, 2003	Strengthening the Commission's Requirements Regarding Auditor Independence
<b>Summary:</b> This release makes technical corrections to rules adopted in Release No. 33-8183 (January 28, 2003).		
<b>Release</b>	<b>Date</b>	<b>Name</b>
33-8177a	Mar. 26, 2003	Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002
<b>Summary:</b> These are technical corrections to rules adopted in Release No. 33-8177 (January 23, 2003).		
33-8216	Mar. 27, 2003	Filing Guidance Related To: Conditions for Use of Non-GAAP Financial Measures; and Insider Trades During Pension Fund Blackout Periods
<b>Summary:</b> This release provides interim guidance regarding the filing of information pursuant to new items requiring public notice of a pension fund blackout period. See Release 34-47225 below.		
33-8128A	Apr. 8, 2003	Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports
<b>Summary:</b> This document contains corrections to final rules that relate to the acceleration of the filing of quarterly and annual reports.		
33-8220	Apr. 9, 2003	Standards Relating to Listed Company Audit Committees
<b>Summary:</b> The rule directs the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Sarbanes-Oxley Act of 2002. These requirements relate to: the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee. Effective Date: Under the rule, listed issuers must be in compliance with the new listing rules by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004.		

**Extract from a June 11, 2003 speech by Roel C. Campos, SEC Commissioner, to the Centre for European Policy Studies:**

The Commission recognized that, when our rules conflict with home country legal requirements, foreign market participants are placed in an impossible position - violate home country law in order to comply with SEC rules. Accordingly, we made accommodations where conflicts of law exist, and where foreign laws and requirements address in alternative fashion the underlying issues in the Act. Ultimately, in implementing the Sarbanes-Oxley Act, the Commission made a number of accommodations for foreign market participants, including:

- Satisfaction of audit committee requirements in the case of foreign private issuers from jurisdictions where a body within the corporate structure that is independent of management is responsible for selecting, compensating, retaining and overseeing outside auditors.
- Allowing non-management employees to serve on audit committees, consistent with “co-determination” and similar requirements in some countries.
- Expanding the definition of an “audit committee financial expert” to include individuals who have expertise in the generally accepted accounting principles of the home country of the issuer.
- Excluding most foreign attorneys not licensed to practice law in the United States from coverage under the SEC's attorney conduct rules. As a general matter, only foreign attorneys who provide advice regarding US securities law may still be subject to the rule.
- The Public Company Accounting Oversight Board, created under the Sarbanes-Oxley Act, appears to have taken a similar approach with its auditor registration rules. The Board recently adopted rules requiring the registration of all public accounting firms, domestic and foreign, that issue or prepare audit reports on the financial statements of US public companies. The rules reflect careful consideration of comment letters from foreign authorities and firms, as well as views obtained at an international roundtable held on March 31. Although the Board determined not to exempt foreign accounting firms from registration, it recognized the need to avoid unnecessary burdens or legal conflicts. To this end, the Board has made certain preliminary accommodations for foreign firms consistent with the spirit and intent of the Sarbanes-Oxley Act and the Board's mandate. These include:
  - Not requiring foreign audit firms to provide registration information to the PCAOB, where the provision of such information would violate home country laws.
  - Granting foreign audit firms an additional six months to register, in recognition of the fact that foreign audit firms will have to assess whether the registration requirements do pose conflict with local law.
  - Limiting registration only to proprietors, partners and principals of foreign audit firms that provide over 10 hours of services on a particular audit.

## CHAPTER VII

### DISCLOSURE OF THE IMPACT OF CORPORATIONS ON SOCIETY: CURRENT TRENDS AND ISSUES

#### SUMMARY OF DISCUSSIONS

Social accounting and reporting as an item for consideration has been brought up by the ISAR group a number of times in the past. It was suggested as an area of future work at the seventeenth and eighteenth sessions of ISAR; it was also discussed at the nineteenth session as part of disclosure requirements on corporate governance. The objective of the twentieth session was to review current trends and issues in the area of corporate social responsibility (CSR) reporting and debate a potential ISAR contribution to work in the area of CSR reporting.

The UNCTAD secretariat provided an overview of its report on the current trends and issues in the area of corporate disclosure of enterprises' impact on society (TD/B/COM.2/ISAR/20). The objective of this report was to provide background information for discussions and to facilitate consideration by ISAR of the re-emerging issue of CSR and its implications for accounting and reporting, including such questions as: Is disclosure needed in relation to CSR? What kind of information should be reported, and should it be harmonized? Is there a need for international benchmarking on CSR reporting? How can the involvement in the process of developing countries and countries with economies in transition be increased? How can disclosure be made to work in practice? Can ISAR add value in the area of CSR reporting?

The discussions that followed reflected participants' interest in the issue of CSR reporting. It was recognized that the topic of CSR reporting cannot be avoided by an organization such as ISAR, which is concerned with financial as well as non-financial reporting issues. Several participants stressed the need for enterprises to disclose their overall impact on society, taking into account the impact of their entire supply chain, without limiting their reporting only to the impact of the enterprise and its subsidiaries. The concern of Governments in developing countries and civil society regarding the impact of multinational enterprises was also mentioned, in relation to their inability to rely on a strong legislative framework and their need to be able to rely on the probity of corporations in their disclosures. The need was voiced several times for a platform of discussion between developed and developing countries on CSR issues, and it was noted that ISAR could provide such a platform.

The report states that CSR is generally understood as actions involving integration of societal concerns into the business policies and operations of enterprises, including environmental, economic and social concerns. It is developing as a result of the growing concerns about the impact that enterprises have on society, particularly as a result of liberalization and globalization.

The problem of the lack of a definition of CSR reporting and its relation to sustainability reporting was raised several times. One speaker's view was that CSR reporting was a sub-element of sustainability reporting, as many enterprises produce CSR reports without raising the issue of the sustainability of their operations. This delegate suggested that ISAR focus on sustainability reporting in order to stay true to the United Nations agenda. Several other participants argued that the boundaries between CSR and sustainability reporting were not very clearly defined and that the two issues were very closely intertwined. It was also noted that sustainability was such a vast and loosely defined concept as to make it impossible for an organization such as ISAR to define what sustainability reporting should encompass.

The question was raised as to whether CSR was a durable concern or a temporary one. In response, a participant pointed out that over 50 per cent of the FTSE 250 were issuing CSR reports – starting from a base of zero in 1990 – thus demonstrating corporate support for CSR and CSR reporting. Another participant mentioned the creation of over 300 social and environmental funds in the last three years in Europe and the growing number of social and environmental rating agencies. Several examples were given of new regulations put in place, mainly in European countries, on CSR and CSR reporting. A participant pointed out that non-financial disclosure had become more important in trade between developing and developed countries, with transnational enterprises increasingly requiring this type of information from their suppliers. In addition, developing countries want to know about TNCs' business principles and the impact of their operations in host countries. It was acknowledged that, although CSR was an agenda driven largely by developed countries, it was here to stay and developing countries had much benefit to derive from it.

The report also reviewed the economic benefits of a socially responsible attitude. At the operational level, the adoption of ethical principles can increase labour productivity and staff commitment. In a buyer-driven market, companies that take responsibility for the conditions under which their suppliers operate are more likely to attract and retain customers. They also achieve better risk management through better control of the supply chain. At the financial level, CSR has an impact because of the growing importance of intangible assets such as brand name and reputation. New CSR indices and ratings ensure that the integration of CSR concerns into the management of a company can provide additional sources of funding by sending positive signals to socially responsible investors. It is also argued that having a CSR policy can positively affect share prices and net income. At the strategic level, a socially responsible attitude implies a longer-term vision and management of economic growth, as well as an improved economic and business environment.

Several participants saw the lack of comparability of CSR reports as a major issue. This situation results partly from the lack of a precise definition of what CSR or sustainability reporting encompasses, and also from the diversity of information requests by stakeholders. Many business and civil society organizations have undertaken to define what should be included in CSR reports, thus producing a large number of indicators. A member of the secretariat highlighted the concern that the plethora of social environmental and developmental indicators led to a lack of consistency and comparability. That person pointed out that the current level of verification of CSR reports is much less systematic and reliable than that of financial reports and therefore cannot compensate for the current lack of consistency and comparability in CSR reporting practices.

The issue of CSR reporting's creating an additional burden for enterprises was raised. In developed countries, where CSR reporting is more advanced, enterprises are deluged with information requests, and the cost of satisfying all stakeholders is prohibitive.

A participant pointed out that new risk management practices mean that transnational enterprises increasingly need to control their whole supply chain, thus pushing for better CSR disclosure from other enterprises in developed and developing countries. Suppliers in developing countries sometimes have to accommodate differing requirements from corporate clients. It was stressed that the work on harmonization and better readability in CSR reporting practices had to be carried out with the caution that this new area of reporting should not become overly burdensome to companies.

It was agreed that much work had already been done to develop indicators, and that, in order to avoid further duplication, ISAR's work had to be based on what had already been achieved. Concerns were raised that working on harmonization of practices at such an early stage could stifle current efforts and creativity. In response, one participant argued that, although social reporting was in its infancy and needed direction, harmonization or a move towards a minimum set of core standards was desirable in order to bring unity to the diversity in this area. This type of work based on existing initiatives or initiatives in development would not affect their creativity but merely avoid creating chaos and increased burdens on enterprises. A participant pointed out that ISAR was a unique forum that could bring together professionals from developing and developed countries to work on the issue of convergence. It was suggested that ISAR undertake research comparing existing indicators in order to distil a set of core indicators. It was also recognised that ISAR could initiate further work on the development of social impact indicators, since currently used indicators focus on corporate social policies rather than impact.

SME reporting was discussed in relation to CSR. One participant pointed out the importance of CSR reporting for small enterprises wanting to use CSR as an intangible asset and a competitive advantage. It was pointed out that SME creation and development depend largely on their financing, and that better financial and non-financial disclosure facilitates their search for finance. It was noted that UNCTAD's expertise in the field in general and ISAR's expertise in particular would benefit work on CSR reporting for SMEs. A participant suggested cooperation between ISAR and the United Nations Environment Programme in this regard.

ISAR agreed that work on CSR reporting should remain within the ECOSOC mandate and the recommendations of the Group of Eminent Persons. ISAR could begin examining existing indicators so that corporate social responsibility reports would be comparable and would not impose unreasonable burdens on enterprises in developing countries. ISAR could also take into consideration the needs of SMEs in reporting on this issue. The UNCTAD secretariat might report back to ISAR on these issues at its twenty-first session.

## I. INTRODUCTION

Concern about the impact of enterprises on society is a global one. The expectations of consumers, employees, investors, business partners and local communities as to the role of businesses in society are increasing. Guidelines, principles and codes are being developed for corporate conduct.

Governments, non-governmental organizations (NGOs) and local communities are demanding increased transparency and accountability, not only in the enterprises' daily business operations but also with regard to how those operations affect society. With the recent financial and accounting scandals and their impact on capital markets and pensions, these concerns have become more acute.

Despite this widespread interest, it is still difficult to assess the impact of an enterprise on society, and even more so to benchmark it. Stakeholder groups design benchmarking tools, professional organizations carry out social audits, Governments legislate for mandatory social reports, rating agencies rank enterprises, and enterprises themselves publish an increasing number of reports on their social performance. These numerous efforts notwithstanding, stakeholders are not satisfied with the reports and demand ever more information on the impact that enterprises have on society, and how they align this impact with society's needs.

These numerous requests for information from investors and civil society impose a growing burden on enterprises, which struggle to respond to the demand. It is increasingly recognized that one of the solutions lies in harmonized corporate reporting that would produce complete, comparable and verifiable information material for all stakeholders.

## **A. Corporate social responsibility**

### **Definition**

Society grants all legal entities, including enterprises, a "licence to operate" by spelling out their rights and duties in laws and regulations. Liberalization and globalization have enabled enterprises to extend their business reach, thus putting them in a position to have an even greater impact on society. Despite the existence at the international level of treaties, agreements and conventions, there is no set of international rules to regulate business activities and their impact on society. This means that the increased power of corporations must be balanced by a sense of ethical business practices. In a world where transnational corporations' economic power compares with that of countries,<sup>1</sup> Governments sometimes find it difficult to balance the need to protect their citizens with the need to attract foreign direct investment.<sup>2</sup>

Most definitions of corporate social responsibility (CSR) describe it as constituting actions whereby enterprises integrate societal concerns into their business policies and operations, including environmental, economic and social concerns. Compliance with the law is the minimum standard to be observed by enterprises. In countries where enterprises' legal obligations are non-existent or not spelt out in detail, it is important that enterprises still make an effort to meet societal expectations. The scope of corporate social responsibility encompasses the direct impacts of enterprises' actions as well as the spillover effects they may have on society. The extent to which enterprises can be held responsible for such externalities is still being debated.

Corporate social responsibility is very closely linked to the concept of "sustainable development". In 1987, the Brundtland Report found that the current model of economic development could not be sustained in the long term, as it depletes natural resources and harms society. It defined "sustainable development" as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs".<sup>3</sup> This concept of sustainable development depends on three key components: environmental protection, economic growth and social equity. At the 1992 United Nations Conference on Environment and Development in Rio de Janeiro, the leaders of over 100 countries adopted Agenda 21, a blueprint for achieving sustainable development in the 21<sup>st</sup> century. Governments that agreed to implement this plan in their countries are monitored by the United Nations Economic and Social Council's Commission on Sustainable Development.

Agenda 21 described transnational corporations as playing a crucial role in the social and economic development of a country.<sup>4</sup>

### **Relevance to preparers and users of corporate reports**

Societal expectations originate from a growing number of interest groups, including shareholders, employees, Governments, non-governmental organizations (NGOs), consumers, and local communities in which businesses operate. A judgement of what constitutes “responsible behaviour” in a particular sector and location can be made only through a dialogue between stakeholders and the enterprises. Transparency and accountability are fundamental to this dialogue. Given the current state of distrust between society and enterprises, corporate claims of good behaviour are met with suspicion if they are not backed by comprehensive and verifiable information. Reporting faithfully on an enterprise’s impact on society helps rebuild trust by demonstrating that the enterprise is open and accountable for the impact of its actions. It also facilitates dialogue and allows stakeholders to identify the problems and design solutions that are acceptable to all parties. The collection of information for such reports can also give the enterprise a better insight in new market opportunities and help improving the management of risks related to the environment or society as a whole. This may in turn lead to better access to financial markets.

Users of accounts traditionally include directors of the board, executive directors, regulators, lenders and investors. Corporate social responsibility is becoming more relevant to them, as directors are under pressure from their investors to disclose in the accounts the impact of environmental and social expenditures, risks and liabilities upon their financial performance. As the number of socially responsible investment funds grows, there is pressure to invest solely in enterprises that can demonstrate the integration of CSR into their operations. Since this type of information is increasingly becoming material to investors, companies need to be able to report on their environmental and social performance in a comparable and verifiable way.

Accounting for environmental and social performance is also crucial for the good management of these issues. It has been argued that improved environmental performance means increased operational efficiency and thus increased shareholder value.<sup>5</sup> The positive link between social performance and financial performance is more difficult to prove, but a number of management theories try to establish it.<sup>6</sup> For example, improved working conditions and involvement of employees in decision-making can increase productivity and the quality of products/services. This also reduces absenteeism. Improved work environments attract and retain staff, particularly skilled ones, with a consequent reduction in turnover, recruitment and training costs. Consumers also are sensitive to an enterprise’s reputation. If two companies produce similar products for the same price, the one with a good social and environmental track record could benefit from increased sales and a larger market share. Finally, environmental and social performance can be properly managed only if it is assessed and compared over time.

## **B. What governs corporations' relations with society**

### **Main international initiatives for CSR**

Work has been carried out at the international level to better define the boundaries of corporate social responsibility. Guidelines for enterprises have been produced by the United Nations Conference on Trade and Development (UNCTAD), the International Labour Organization (ILO), and the Organisation for Economic Co-operation and Development (OECD). The United Nations Global Compact is a coalition of United Nations (UN) agencies and enterprises that aim at promoting a selection of these guidelines. Other initiatives include the work carried out at the level of the European Union, which is still at a very early stage.

The existence of an increasing number of global conventions and guidelines for CSR and the growing general awareness of CSR issues in developed and developing countries help enterprises to integrate CSR into their everyday business and operations. The number and the diversity of the groups developing these initiatives show great creativity, but they are uncoordinated and so generate confusion. For example, some stakeholders' groups design new CSR tools that duplicate other existing ones, and fail to work on certain types of tools that are most needed but ignored by all. A recent survey of initiatives<sup>7</sup> has demonstrated that a myriad of tools have been developed to help enterprises integrate CSR into their visions, policies and strategies, but hardly any have been devised to help enterprises report on their impact on society. This has generated confusion for enterprises that are faced with demands from so many initiatives.

### **Codes of conduct**

There is no consensus on whether corporate social responsibility rules should be voluntary or mandatory. For a while corporate self-regulation and codes of conducts – designed by enterprises to define their environmental and social responsibilities – were seen as the way forward in CSR. The number of codes of conduct increased exponentially over the last decade.<sup>8</sup> They are based on codes developed by UN agencies, the ILO, the OECD, Governments, industry and stakeholders' groups. However, codes developed by corporations are often limited in scope and application. They tend to be adopted by enterprises in which brand names and corporate image are important. Many enterprises have adopted a code of conduct in reaction to public criticism in developed country markets. These codes often focus on issues that concern the well-being of populations in home as well as host countries. There is a danger that these codes, if implemented uniformly, will have a damaging effect on certain societies, owing to fundamental cultural and economic differences. It can also be argued that the lack of monitoring of the implementation of codes decreases their usefulness in the adaptation of the way in which enterprises conduct business.<sup>9</sup>

The difference between a code that is merely a public relations exercise and one that allows real control over business operations is the transparency and effectiveness of its implementation and its verification. Most codes do not have a mechanism for accountability or follow-up.<sup>10</sup> The most commonly used of these processes – the signature of executive officers – is used in less than 40 per cent of the cases. Mechanisms for “whistle blowers” exist in only 20 per cent of cases and training for compliance in less than 15 per cent. Periodic review by managers happens in less than 3 per cent of the cases and external verification even less frequently.<sup>11</sup> Given this poor record, it is increasingly recognized that voluntary codes of conduct are not enough to ensure a level playing field in corporate social responsibility.

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**International and national law**<sup>12</sup>

At international and national levels, the legal framework in relation to corporate social responsibility is changing. The legal risk to enterprises with regard to their impact on people and the environment is growing and has a direct impact on the business. Insurers' and investors' perception of the legal risks faced by an enterprise can lead to higher insurance premiums and increased cost of capital. The potential liabilities can affect share prices. In this context, enterprises need to assess and manage this risk, and support the universal application of internationally agreed minimum standards – for example, in the area of environmental protection – thus creating a level playing field.

International law, through treaties, agreements, conventions and case law, covers issues such as environmental, consumer and health protection, labour and human rights, fair business practices, and corporate governance. Numerous labour and environmental conventions hold signatory countries responsible for ensuring the application of certain principles.<sup>13</sup> The OECD Guidelines for Multinational Enterprises, although voluntary for enterprises, politically bind the signatory countries to set up national contact points (NCPs) through which enterprises can be investigated for not abiding by the Guidelines.<sup>14</sup> However, NCPs have yet to function in an effective manner. The number of legislative initiatives undertaken is on the increase, owing to public pressure.

Certain national laws apply internationally. The United States' Alien Tort Claims Act makes it possible for foreign citizens to lodge claims against American transnational corporations and American-based foreign parent companies for actions in violation of the law of nations or a treaty signed by the United States. Increasingly, principles of civil liability also give rise to litigation against parent companies of corporate groups.

At the national level, laws regulate the relationships between enterprises and society by ensuring the protection of shareholders as well as other stakeholders, including employees and consumers. Certain voluntary CSR initiatives such as codes of conduct included in contracts with suppliers can become legally binding as de facto minimum standards. Social labelling and certification schemes incorporated into supply chain contracts become binding.<sup>15</sup> Published codes of conduct, enterprise reports and press releases may be scrutinized under laws on misrepresentation. Codes of conduct and public statements on an enterprise's values can also constitute a "constructive obligation" as they indicate that the enterprise accepts certain responsibilities, thus creating a valid expectation on the part of stakeholders that these responsibilities will be fulfilled.

There are also some legislative developments in the area of social reporting. Certain Governments feel the necessity for increased disclosure and transparency in the area of CSR. Their requirements are generally partial in their coverage and mainly environmental or labour-related. France<sup>16</sup> and Belgium<sup>17</sup> require enterprises and subsidiaries located on their national territory to disclose statistical information on their workforce and its fluctuation, remuneration, health and safety, working conditions, training, labour relations, living conditions, and measures taken in favour of employment. France has also required since 2002 that all enterprises listed on the Premier Marché report on employee, community and environmental issues, how corporations' subsidiaries respect the ILO fundamental conventions and how corporations promote these conventions among their subcontractors. In the Netherlands, following a Government request, the Council on Annual Reporting has published guidelines for including CSR information in the annual director's report, as well as

for separate CSR reporting. Denmark, the Netherlands, Norway and Sweden, have introduced mandatory requirements for environmental reporting for certain enterprises.<sup>18</sup>

The United Kingdom is considering this issue as part of its revised Company Law,<sup>19</sup> although no decision has yet been made. The current proposal includes mandatory operating and financial review (OFR) which would cover an enterprise's objectives, strategy and drivers of performance; a review of the business; the dynamics of the business; the enterprise's approach to corporate governance (values and structure); an account of the key relationships on which its success depends; the enterprise's policies and performance on environmental, community, social, ethical and reputational issues; and receipts from and returns to shareholders. The United Kingdom Pensions Act of 1995<sup>20</sup> requires pension funds to disclose "the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments". Australia, Belgium, Germany and Sweden have introduced, or are in the process of introducing, broadly similar legislation on socially responsible investment.

### **Corporate governance**

Corporate governance has been catapulted to the top of the political and business agenda by the recent accounting and management scandals such as Enron, WorldCom, Tyco, Ahold and others. If effective, improved corporate governance would ensure that corporate leadership is efficient, honest, responsible and accountable. Although, it is still argued by some that enterprises are responsible solely to their shareholders, international corporate governance guidelines increasingly recognize that enterprises need to consider all their stakeholders, thus making a step towards the integration of CSR issues in the governance of an enterprise. Principles of corporate governance agreed among OECD countries – the OECD Principles of Corporate Governance<sup>21</sup> – state that the Board of Directors (BoD) should ensure that the enterprise is in compliance with applicable laws, and is expected to take into account various stakeholders' interests, including those of employees, creditors, customers, suppliers and local communities.<sup>22</sup> However, it seems that not all BoDs take into account stakeholders' interests while performing their primary functions, which include guiding corporate strategy and setting performance objectives. A recent survey of 500 businesses in the United Kingdom found that only four out of 10 boards discuss social and environmental issues, only a third have a board member who has an environmental remit and only a fifth have one with an interest in social issues.<sup>23</sup> Boards are also responsible for ensuring that appropriate systems of control are in place, in particular those that monitor risk, including potential environmental and social liabilities.

Information is a major concern for BoDs. Board members must have access to accurate, timely and relevant information to support their decision-making. Also, they are in charge of overseeing the process of disclosure to and communications with stakeholders, which helps to improve public understanding of the structure and activities of the enterprise, corporate policies and performance with respect to environmental and ethical standards, and the enterprise's relationship with the communities in which they operate. A number of pronouncements, such as the OECD Principles, the Commonwealth Association for Corporate Governance (CACG) Guidelines,<sup>24</sup> the King Report on Corporate Governance 2002<sup>25</sup> and ISAR's Transparency and Disclosure Requirements for Corporate Governance stress the importance of communicating with stakeholders. They recommend that enterprises disclose financial and non-financial information, including policies on business ethics and the environment, governance structures pertaining to those policies, foreseeable risk factors,

issues regarding employees and other stakeholders, performance in connection with environmental and social responsibility and the impact of this performance on the enterprise's sustainability. These requirements, although a first step towards CSR reporting, are far from fully satisfying the demand for CSR information.

Some of the major stock exchanges require or are considering requiring disclosure of non-financial data on listed enterprises' social and environmental policies and related management systems, as well as on corporate governance. The Australian Stock Exchange (ASX) requires all entities to include in their annual report a statement disclosing the extent to which the enterprise has followed the best practice set by the ASX Corporate Governance Council.<sup>26</sup> The New York Stock Exchange (NYSE) submitted to the Securities and Exchange Commission (SEC) in April 2003 a rule amending its corporate governance proposals, which includes new corporate governance standards.<sup>27</sup> These recommendations are currently under SEC review.

### **Public pressure and reputational risk**

The emergence of powerful NGOs, coupled with progress in the area of information technology means that cases of social irresponsibility make front-page news, thus increasing the enterprises' reputational risk. The business community recognizes reputation as a valuable asset since it affects the relationship of the enterprise with its customers, employees and investors. Managers need to take into account that any wrongdoing anywhere in the world can be transmitted to a worldwide audience, and impact on sales, market share, staff turnover, access to capital and market valuation of their enterprise. It is all the more important to assess and manage reputational risk, since a good reputation is easily tainted and difficult to restore. Arthur Andersen's loss of reputation in the wake of the Enron scandal cost the enterprise its very existence.

Many of these NGOs demand transparency and accountability on the part of enterprises. One of the most high-profile examples is the International Right to Know Campaign (IRTK), a United States-based coalition of more than 200 environmental, labour, social justice and human rights organizations. This campaign requires enterprises based in the United States or traded on American stock exchanges, as well as their foreign subsidiaries and major contractors, to disclose information on overseas operations along the lines of the United States Emergency Planning and Community Right to Know Act (EPCRA) and other American disclosure standards.<sup>28</sup>

The Publish What You Pay (PWYP) campaign, initiated by George Soros and a coalition of 110 NGOs, demands that Governments, stock market regulators and international accounting standards require international oil, gas and mining enterprises to publish net taxes, fees, royalties and other payments made to Governments of countries in which they operate. The G8 Governments agreed in June 2003 to pilot such an initiative.<sup>29</sup> At the public hearing on PWYP at the European Parliament in June, the Committee on Development and Cooperation declared its support for a mandatory approach to delivering transparency of oil, gas and mining company payments to national Governments.<sup>30</sup>

### **Investors' pressure**

Institutional investors, either for ethical reasons or because they are concerned with their investments' capacity to create and preserve shareholder value, take an increasing

interest in enterprises' social and environmental performance and risk management. A recent study investigating the relationship between doing business ethically and financial performance showed that enterprises committed to ethical behaviour performed better financially over the long term than enterprises lacking that commitment.<sup>31</sup> Investment decisions are based on corporate reports, rating agencies' social and environmental screening, and sustainability indexes such as the KLD Domini 400 Social Index, the Dow Jones Sustainability Index or the FTSE4GOOD Index. These indexes track the financial performance of enterprises that have made sustainability a key driver of business strategy.

The performance of sustainability indexes indicates that investors value more highly companies that are less exposed to social, environmental and ethical risks. The Domini 400 Social Index, monitoring the performance of 400 US companies, has outperformed the Standard & Poor 500 by more than 1 per cent on an annualized return basis and on a risk-adjusted basis since its inception in May 1990.<sup>32</sup> The Dow Jones Sustainable Index (DJSI), which monitors 310 of the largest companies from 23 countries, has grown by 180 per cent since 1993 compared with 125 per cent for the Dow Jones global Index over the same period.<sup>33</sup> Since its launch in 1994, it has also outperformed the FTSE World Index by 17 per cent.<sup>34</sup>

The number and size of ethical investment funds is increasing, although they still represent a small proportion of total managed equity. Socially responsible investing (SRI) is a growing trend that unites investors that are pursuing financial as well as social returns from their investments. Total assets involved in social investing grew from \$40 billion in 1984 to \$639 billion in 1995, and to over \$2.32 trillion in 2001<sup>35</sup>. In the United States, SRI has grown between 1999 and 2001 in an otherwise depressed market. Whereas during the first 9 months of 2001 the total amount invested into mutual funds dropped by 94 per cent, there was only a 54 per cent drop for socially screened funds.<sup>36</sup> In Western Europe, SRI has achieved 100 per cent growth rates in the recent years, although it still represents less than 1 per cent of total managed equity assets.<sup>37</sup> The trend in SRI funds is to shift from negative screening (i.e. excluding tobacco, alcohol, arms, etc.) to positive screening whereby investors support enterprises that produce or use environmentally friendly products or production methods and engage in socially responsible business practices. Many of these screening methods take into account internationally agreed principles such as the OECD Guidelines for Multinational Enterprises, the Declaration of Human Rights and the ILO Principles.<sup>38</sup>

Investor pressure can take forms other than selective investing. Shareholder activism is another, growing tactic. As part owners of publicly traded enterprises shareholders can initiate dialogue with managers through letters or meetings, and file shareholders' resolutions. Shareholders' resolutions are proposals introduced by shareholders, individually or in groups, that are discussed and voted upon during the enterprise's annual meeting. Proposals have to receive 50 per cent of the votes for the management to comply with them. Resolutions related to social or environmental issues usually do not achieve such a result, but they contribute to raising awareness, attracting media attention and increasing pressure on executive managers.<sup>39</sup> It is difficult to assess the impact of shareholders' resolutions as enterprises can choose to implement the changes proposed by the shareholders without acknowledging the pressure they have been under to do so.<sup>40</sup>

Banks also are awakening to reputational risk. Four large banks – ABN Amro, Barclays, Citibank and WestLB – have drafted the "Equator Principles" on project financing in collaboration with the World Bank's International Finance Corporation. These principles

are social and environmental guidelines for project finance in emerging markets, and include safeguards ranging from environmental assessment and natural habitats to indigenous peoples and child and forced labour. Five other banks<sup>41</sup> have recently agreed to commit themselves to these principles, with another four still considering whether to do so.<sup>42</sup>

### **C. Disclosure of corporate social responsibility**

Enterprises are under increasing pressure to report on the impact they have on society and on how they manage this impact. Their coverage is much wider than just employment issues (see paragraph 0). Such reports carry a variety of labels, but they are most often called environmental and/or social reports, or sustainability reports. A sustainability report is more comprehensive than an environmental and/or a social report, first because it includes the economic impact of the organizations, and second because not only does it assess the enterprise's impact on society and compare its performance over the years, but also it assesses the sustainability of the enterprise's operations and products in relation to the development of society.

### **Recent trends in social reporting**

Modern social accounting first attracted the attention of Governments, businesses, academics and professional accounting bodies in the first half of the 1970s.<sup>43</sup> This widespread interest withered over the second half of that decade, only to re-emerge in the wake of environmental disasters such as Bhopal and Exxon Valdez. Enterprises have published an increasing number of environmental reports over the last 10 years. While enterprises that have a large environmental footprint were among the first to report on their environmental performance, environmental reporting has gradually caught on with other enterprises. This trend, triggered by the public's concern for the environment, has been supported by the development of laws and regulations that require enterprises to report on their environmental performance in countries, for example Australia, Canada, Denmark, the Netherlands, Norway, Sweden and the United States. Many guidelines on the structure and content of environmental reports were elaborated in the early 1990s. ISAR published guidelines on Accounting and Financial Reporting for Environmental Costs and Liabilities, based on best practices, to ensure that standards setters did not adopt different solutions for the same problems. ISAR also created a set of five core eco-efficiency indicators to help harmonize internationally the assessment of how the environmental performance affects the financial results of an enterprise. International organizations such as the International Auditing Practices Committee of the International Federation of Accountants, the Accounting Advisory Forum of the European Union and the European Federation of Accountants investigated the relationships between environmental and financial reporting.<sup>44</sup> Despite a general move towards a standard format for reporting, the variety in the reports is such that benchmarking is still difficult.

As much work has already been done on environmental accounting and reporting by ISAR as well as by other organizations, the rest of this paper will focus on the social components of reports.

Over the last five years, other social topics have been added to environmental issues. Today, environmental reports account for 64 per cent of the total number of social reports. Again, this evolution has been triggered by stakeholders' concern, and is supported by an increasing number of laws, regulations and guidelines. A survey of the top 250 enterprises worldwide and the top 100 in 19 countries shows that fewer than 500 of them produced an

environmental, social or sustainability report in 2002.<sup>45</sup> This represents less than 1 per cent of the 65,000 transnational enterprises in the world.

Reporting is not limited to heavy-impact sectors such as chemicals and mining, but is also found in most economic sectors, including food and beverages, communication and media, transport, and utilities. Social reporting is not restricted to Western Europe and North America but is emerging in Latin America, Eastern Europe, Africa and Asia.

Enterprises from emerging economies that report on environmental and social issues say that they do so because of their commitment to transparency and accountability, and because measuring their impact on society helps them manage it. These enterprises are subject to less pressure to report from Governments and domestic investors than those based in Western countries. Some even complain that they do not receive any feedback from civil society organizations in their own countries, although this is a complaint that they share with Western-based enterprises. The lack of pressure from developing country Governments also benefits subsidiaries of transnational corporations, of which only a few report on their local engagements and impact on local communities. External pressure to report mainly comes from stock market authorities in Europe or North America and from socially responsible funds.<sup>46</sup>

The content and quality of social reports vary greatly, from public relations tools to sophisticated reports of real efforts to integrate societal concerns into everyday business operations.<sup>47</sup> A recent quality assessment of 100 social reports from around the world concludes that although the average number of pages has increased by 45 per cent, the reports' quality has not increased compared to the quality level in 2000.<sup>48</sup> The content of social reports is generally analysed in terms of economic, environmental and social issues. Economic performance reporting includes wages and benefits, productivity, job creation, outsourcing, research and development, and investments in training and other forms of human capital – all of which can be quantified. Environmental issues include the impact of production processes, products and services on air, land, biodiversity and human health. The quality of reports on environmental issues, thanks to the existence of a number of recognized environmental metrics such as ISAR's eco-efficiency indicators, is generally better than the quality of reports on social issues.

Social issues typically include workplace health and safety, employee satisfaction and corporate philanthropy, as well as labour and human rights, diversity of the workforce and supplier relations. Social disclosure often has an internal focus, with employee data, health and safety, and staff surveys being more commonly reported than data covering local community and wider society issues.<sup>49</sup> For those social issues for which it is more difficult to set a quantifiable performance metric, the reporting remains scarce and qualitative. For example, only a minority of reports cover human rights, supplier relations, child labour, freedom of association, collective bargaining, fair trade, working hours, the employment of country nationals, how much and where taxation is paid, and funding of pension schemes. Provided that they do not threaten the enterprise's competitive position, disclosure of these issues would be of great interest to employees, customers, host country Governments and socially responsible investors.

Some enterprises report on stakeholder dialogue, which usually takes the form of inclusion in their report of stakeholder statements – sometimes negative but mostly positive – staff surveys, and community panels and forums.<sup>50</sup> However, most enterprises seem to

consider stakeholder dialogue as an end in itself, and rarely do reports show a link between stakeholder engagement and enterprises' decision-making processes.

Despite the lack of internationally accepted standards for providing assurance on social reports, enterprises are increasingly seeking external assurance for their reports. A significant number of reports were verified in 2002 by a third party – respectively 29 per cent and 27 per cent for GFT250 and Top 100 enterprises – and verification was made by a major accountancy firm in 65 per cent of cases.<sup>51</sup>

### **Current voluntary corporate reporting initiatives**

A growing number of initiatives aimed at assessing the impact of enterprises on society are constantly emerging. Specialized consultancies offer their services to enterprises wanting to produce a social report. The methodologies used by these consultancies all differ from one another, which ensures that they keep an edge on the competition. A multitude of CSR performance benchmarking programmes have been developed by stakeholder groups, in addition to rating agencies and sustainability index publishers. These are swamping enterprises with questionnaires. A recent survey of European enterprises shows that although over 80 per cent of investor relations practitioners believe that CSR reporting is a central part of a good investors' relations programme and 75 per cent of them think that CSR is important in a bull as well as in a bear market, the large majority recognizes that questionnaire fatigue is a real problem.<sup>52</sup> Enterprises are asking for standardization of the information requested from them.

A few stakeholder initiatives, generally including representatives from the private sector, aim at setting reporting frameworks and indicators that could help to harmonize information requirements. Although they individually contribute to defining certain areas of social reporting, their variety and limited scope work against the establishment of uniform formats and content. They include the Global Reporting Initiative (GRI), the Sustainability Reporting Project of the World Business Council for Sustainable Development (WBCSD), the Business in the Community (BITC) Corporate Impact Reporting Initiative and AccountAbility's AA1000 series. As the purpose of this report is to review more particularly those recent initiatives that concentrate on the social aspects of reporting, initiatives on environmental reporting are not included here.

The GRI guidelines<sup>53</sup> contain reporting principles to be followed by preparers, specify report content and suggest reporting indicators, including 50 core environmental, social and economic indicators and 47 additional ones. The "core" indicators are considered to be significant to most enterprises and material to most stakeholders.

The GRI has made a point of being as inclusive as possible in its deliberations, and any interested and committed party could join and participate in the development of the guidelines. Consequently, it has proved difficult to limit the number of indicators. Each of the GRI's technical and governance bodies included representation from business, civil society, accountancy and labour, from various regions – although few developing countries have participated.

The number and the diversity of indicators have raised questions in the business community as to the cost of producing a report in accordance with the guidelines<sup>54</sup>. It is also argued that the large number of indicators impairs the readability of the report. As a result,

most “GRI reporters” choose to use indicators that they feel that are most relevant to them. A number of indicators are in fact a simple disclosure of policies and practices. Apart from the evident completeness and comparability problem this poses, the fact that not all selected indicators have a clear link to sustainable development or even performance allows enterprises using the guidelines to produce reports that do not address their impacts on society. There are also enterprises that argue that there is a danger that sensitive proprietary information could be disclosed via some of the indicators. In response to these criticisms, the GRI answers that the guidelines are still evolving. It is learning from its own experience and from stakeholders’ comments, and its approach is being refined by the development of sectoral standards. To date, 290 organizations refer to the guidelines in their reports, but only eight report “in accordance” with the guidelines.<sup>55</sup> Such references present another danger in that enterprises could mislead users into thinking that enterprises are complying with the guidelines.

Other initiatives are less comprehensive in scope and tackle only a particular aspect of social reporting. For example the WBCSD,<sup>56</sup> an organization representing the international business community, runs the Sustainability Reporting project which has led to the development of a web-based reporting platform to give guidance to member enterprises in their compilation of sustainable development reports. The users of this platform can find guidance on reporting, monitoring and measuring, as well as an inventory of best practice reports, including triple bottom line, ethical and social, environmental, and health and safety reports. This tool does not, however, provide a reporting framework. Because this initiative informs the user about what is being done by a limited number of reporters rather than prescribing a specific reporting method, it has the potential to generate greater reporting diversity among reporters.

BITC is a non-profit organization based in the United Kingdom with about 700 members, including 75 of the United Kingdom’s FTSE 100 enterprises.<sup>57</sup> BITC’s Corporate Impact Reporting project recommends a set of 55 core indicators by which an enterprise’s impact on society can be measured. Efforts were made to include information that is material. The indicators are subdivided into sets of indicators related to the market place, the environment, the workplace, the community and human rights. These indicators are accompanied by a framework to measure and report on responsible business practices. BITC stresses that this reporting methodology provides a picture of enterprises’ CSR activities and performances, but does not allow for comparison and benchmarking. Some of its core indicators have been criticized by some enterprises for being irrelevant to their particular sectors, and so far only twenty UK-based enterprises participate in this initiative.

The Institute of Social and Ethical Accountability (or AccountAbility) is a UK-based organization.<sup>58</sup> Members include enterprises, NGOs, business schools and service providers. It promotes best practices in social and ethical accounting, auditing and reporting, and develops standards and accreditation procedures. The AA1000 is a tool for social and ethical accounting, auditing and reporting. The AA1000 Framework was established in 1999 to provide guidance on how an organization can improve its accountability and establish effective stakeholder engagement. Through training and dialogue, enterprises are encouraged to define goals and targets, measure progress made against these targets, audit and report on performance, and develop feedback mechanisms. The AA1000 Framework, now known as the AA1000 Series, was extended in 2002 to include specialized modules for accountability practitioners such as those on assurance. However, the AA1000 Series has not been recognized by internationally agreed standard-setters.

#### **D. Major issues faced by preparers and users of reports Purpose**

Preparers of reports can be divided into two groups. First are those that use international guidelines pertaining to corporate social responsibility (see “Main international initiatives for CSR“ above) to define the content of their social reports or seek the help of professional auditors or consultancies that focus on making the report a monitoring and management tool. Second are those that outsource the task of producing their reports to consultants whose core competency is in communication. The number of enterprises offering reporting services is growing.

The methodology used to produce a social report could be an indicator of the level of commitment on the part of enterprises to use the reporting exercise as a tool to assess and modify their business operations in order to improve their impact on society. It is important that when an enterprise aims at modifying its environmental and social impact, it analyses its current impact, sets targets and puts in place management systems that include monitoring and reporting, just as it does for the financial aspects of its business. Reporting to external stakeholders should not be an end in itself but merely the reflection of the enterprise’s business processes and their results. Currently, many environmental and social reports develop the right rhetoric on the responsibility of enterprises to society and its importance to the sustainability of their operations, but very few report on the management systems that are – or should be – in place to support and implement this goal and their impact on performance.

#### **Comparability of reports**

Each enterprise’s social report has its own format and substance, depending on the approach chosen by the reporting enterprise, and its perception of who its stakeholders are and of what their needs are. Many reports try to provide all interest groups with all the information they require in the same document. This leads to a mass of diverse information, which makes it difficult to have a clear picture of an enterprise’s values, commitment to these values and consequent impact on society. It also makes it difficult to compare performances among enterprises.

In order to illustrate the variety of reporting formats, we have compared three examples of the most recent social reports published by two oil companies with years of environmental reporting experience and by a bank which was named best sustainability report producer by the Association of Certified Chartered Accountants. Differences in the very names of the reports reviewed indicate the variety in the three enterprises’ approaches to social reporting. The number of pages, which ranges from 34 to 102, highlights the dilemma that corporations face – between reporting in an exhaustive manner and producing a report that is quickly and easily read. All three enterprises use quantitative indicators to report on their performances, but some accompany them with lengthy explanations, which inform the reader in depth but also multiply the number of pages he or she has to get through to form an opinion on the enterprise’s overall performance.

The lack of comparability of reports increases investors’ need for benchmarking tools such as rating agencies. The amount of information required by these agencies and the multiplication of questionnaires to be filled in by enterprises tie up a growing part of their resources.

## **Reporting medium**

Most social reports are produced as stand-alone reports, distinct from the annual financial reports. This indicates a divide in the preparers' minds between the interests of investors and those of other stakeholders, and between financial performance and environmental and social performance. The distribution and the readership of social reports are uncertain. In an effort to reach out to as many stakeholders as possible, many reporters publish their social reports on their website in a portable document format (pdf) – readers can save and keep the report in its electronic format and make a printed copy of it. Although it still excludes those stakeholders who do not have access to the Internet, this method substantially increases the potential readership while keeping distribution costs low. A growing number of enterprises now publish their reporting information on web pages only. This method has the advantage of enabling enterprises to update their performance information instantly. On the other hand, it decreases the comparability of the data provided, and all information published cannot be verified professionally. From the point of view of the readers, websites can make access to information more difficult and confusing than reports, particularly in the case of a large website with many levels. The Association of British Insurers (ABI) advocates in its Disclosure Guidelines on Socially-Responsible Investment 2003<sup>59</sup> that disclosure of social, environmental and ethical matters “should be made in the annual report, and not separately as part of the summary accounts or on a web site dedicated to social responsibility”. The ABI views this as a minimum requirement that does not impose an unnecessary burden on enterprises.

## **Materiality**

Corporate reporting should be comprehensive and take into consideration all material aspects of business operations. Traditionally, corporate reports seem to focus on quantifiable parameters that go into the financial statements. Reporting on the impact of enterprises on society involves various qualitative parameters. This problem mainly affects social reporting, as environmental indicators have been elaborated by a number of organizations, including ISAR.

The task of establishing a materiality threshold becomes more complex owing to the variety of qualitative indicators that need to be taken into consideration for social reporting. The varied readership of such reports leads to different information demands. Most reporting guidelines state that the first step an enterprise must take towards social disclosure is to define who its stakeholders are, and establish a dialogue with them in order to determine what information is material to them. This dialogue can take place within the day-to-day business, as some departments within the enterprise are already in contact with stakeholders such as investors, customers or the local community. Stakeholder dialogue can also take place through international, national or industry initiatives.

Enterprises' efforts to respond to all stakeholders' demands lead to the publication of indiscriminate information, and thus to a lack of readability of social reports. The specific information needs of different audiences could be better addressed through other communication channels. Reports should contain only information that is material to most or all of the stakeholders. In order to make this possible, the definition of materiality may need to be explored to reflect investors' new environmental and social concerns, and to include stakeholders' information needs. It is important, however, to consider the issue of confidentiality of information. Just as in financial reporting practices, social reporting should

not lead to the disclosure of information that could jeopardize the competitive position of the enterprise.

### **Verification**

Verification of environmental and social reporting is necessary for it to be credible. As in financial accounting, it must be done by competent and independent auditors who were not involved in the production of the environmental and social accounts. The International Federation of Accountants' International Standard on Assurance Engagements are applicable to non-financial assurance engagements, but further specific standards for verifying social reports need to be developed. As there are no internationally accepted standards for providing assurance on social reports, verification methods are defined on a case-by-case basis. A few organizations, such as the Fédération des Experts Comptables Européens,<sup>60</sup> the Global Reporting Initiative and AccountAbility attempt to give guidelines on verification. A large proportion of reports are audited by certification bodies, consulting or technical firms, although in the majority of cases verification statements are signed by one of the major accounting firms.

In a quest for credibility, report preparers increasingly have recourse to verifiers. However, the lack of audit standards for non-financial information is a major hindrance to that effort. A 2002 survey<sup>61</sup> shows that the choice of verifier depends on the audience. Enterprises that target their shareholders choose to employ a large accountancy firm. When the favoured audience is the stakeholders, enterprises prefer to use the services of specialist environmental and social consultancies, or NGOs and “celebrities” in the sustainability field. The choice between celebrity endorsement and specialized consultancy verification depends on the willingness of the enterprise to question the effectiveness of its management processes and learn how to modify them. Traditional auditors focus on the accuracy and reliability of data and include detailed disclaimers perhaps because of their professional liabilities, but do not provide the same learning opportunities as specialized consultancies do. On the other hand, their methodologies are more uniform than those of consultancies, and they are skilled at evaluating internal control systems.

Verifiers need to understand the business operations as well as environmental and social issues, and have genuine independence, and a robust and transparent approach that allows an enterprise to learn while delivering external credibility. This can be achieved by multidisciplinary teams. Guidelines are needed for the verification procedure to be followed by external experts and on the preparation of the reports.

### **E. Conclusion**

Governments and policymakers need to be able to assess the impact of enterprises on society in order to give them licence to operate and ensure that the benefits outweigh the costs. The first step is to determine what information is needed and to ensure that they receive this information in a regular and consistent manner. This report reviewed the various factors driving enterprises to increasingly integrate social concerns in their business operations, and to report on their social performances. These forces are deep rooted and likely to last. The report has then examined the current state of social reporting as well as the major initiatives taken by stakeholders and enterprises to define an appropriate reporting model. The current financial reporting framework takes into consideration primarily economic events that increase or decrease the value of an enterprise's assets and liabilities. In that, it does not take into account the fact that the value of assets and liabilities of an enterprise is increasingly

affected by factors pertaining to corporate social responsibility. Although there are improvements in the practice of social reporting, there are still some major issues to be solved such as the purpose, comparability and materiality of reports, the reporting medium and the verification of the data provided in them. This report has shown that stakeholders' and enterprises' initiatives are unlikely to solve these issues and result in a harmonization of social reporting.

In order to achieve comparability of social disclosure at the international level, there is a need for a global consensus on social reporting formats and content. Further work seems to be needed in order to improve the comparability and usefulness of information provided in social reports. In particular, it might be useful to focus further discussions on the following two areas:

- The current efforts by companies to respond to the multiple demands for information lead to an increase in the volume of information provided by enterprises, thus increasing the cost of reporting without entirely meeting stakeholders' needs. Is there a need for further work to determine the most relevant qualitative items that would reflect the impact of enterprises' social policies?
- Is there a need for additional input on a social reporting format, in particular in terms of harmonizing its content and improving the comparability of information?

If this is the case, what role can ISAR play in the process of resolving these issues?

## ADDENDUM TO THE UNCTAD SECRETARIAT REPORT

### Appendix 1: Examples of definitions of CSR

The definition of corporate social responsibility has undergone substantial modifications overtime, and it is still evolving along with society and society's expectations. There is no globally accepted definition of CSR, nor is there a consensus on a definite list of the issues it encompasses. It is generally agreed that CSR neither is corporate philanthropy nor is it strict compliance with law. The common denominator to most definitions is that CSR is a concept whereby enterprises integrate social and environmental concerns in their business policies and operations, with a view to improve their impact on society. Examples of definitions:

#### Private-sector organizations

##### *Business for Social Responsibility (BSR)*

“CSR is operating a business in a manner that meets or exceeds the ethical, legal, commercial and public expectations that society has of business. CSR is seen by leadership companies as more than a collection of discrete practices or occasional gestures, or initiatives motivated by marketing, public relations or other business benefits. Rather, it is viewed as a comprehensive set of policies, practices and programs that are integrated throughout business operations, and decision-making processes that are supported and rewarded by top management.”

##### *World Business Council for Sustainable Development (WBCSD)*

“Corporate Social Responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large.”

##### *International Business Leaders Forum (IBLF)*

“Corporate Social Responsibility means open and transparent business practices that are based on ethical values and respect for employees, communities and the environment. It is designed to deliver sustainable value to society at large, as well as to shareholders.”

##### *International Chamber of Commerce (ICC)*

“The voluntary commitment by business to manage its activities in a responsible way.”

##### *Empresa*

CSR “generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities and the environment.”

#### International organizations

##### *United Nations*

The United Nations do not add another definition of CSR to the numerous existing ones, but broaden the concept of corporate social responsibility by using the term *global corporate citizenship*, which involves both the rights and responsibilities of TNCs in the international context. Multinational corporations can demonstrate “good corporate citizenship” by “embracing and enacting, both in their individual corporate practices and by supporting appropriate public policies, a number of universally-agreed values and principles” in the sectors of human rights, labour conditions and environment protection.

*United Nations Research Institute for Sustainable Development (UNRISD)*

UNRISD attempts to clarify the meaning of CSR by citing the following academics: corporate social responsibility “is the ethical behaviour of a company towards society. [It involves] management acting responsibly in its relationship with other stakeholders who have a legitimate interest in the business – not just the shareholders” (Schmidheiny et al, 1997:3). The concept may also embrace values associated with environmental protection. While often used in a broad sense, strictly speaking, the notion of responsibility is restricted to the realms of ethics and principles and not concrete actions or outcomes. For this reason there is considerable interest in the concept of corporate social performance, which includes not only motivating principles, but also processes (for example, the adaptation of management systems and technologies), and observable outcomes or impacts on stakeholders (Hopkins, 1997; Wood, 1991).

*World Bank*

“Corporate social responsibility, or CSR, is the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life, in ways that are both good for business and good for development.”

*World Economic Forum*

“Corporate citizenship can be defined as the contribution a company makes to society through its core business activities, its social investment and philanthropy programmes, and its engagement in public policy. The manner in which a company manages its economic, social and environmental relationships, as well as those with different stakeholders, in particular shareholders, employees, customers, business partners, governments and communities determines its impact.”

*OECD*

“Corporate responsibility involves the effectiveness of the “fit” businesses develop with the societies in which they operate. The core element of corporate responsibility concerns business activity itself.”

**Civil society organizations**

*Center for Corporate Citizenship at Boston College*

“Corporate citizenship refers to the way a company integrates basic social values with everyday business practices, operations and policies. A corporate citizenship company understands that its own success is intertwined with societal health and well-being. Therefore, it takes into account its impact on all stakeholders, including employees, customers, communities, suppliers, and the natural environment.”

*Taskforce on the Churches and Corporate Responsibility (TCCR)*

Socially responsible corporations have a “stake in ensuring people are treated properly, receive fair and equitable wages, and operate under safe working conditions”. They must “take their responsibilities seriously and become involved in designing, implementing and monitoring social responsibility performance.”

*National Policy Association*

“Corporate responsibility is not just about ethical behaviour and accounting practices, it is also about how companies act towards their stakeholders as well as their shareholders”.

*Amnesty International*

“Economic actors – be they companies or international financial institutions – are accountable for the human rights impact of their activities.” Amnesty International considers it is in the responsibility of enterprises to “take into account the human rights impact of all aspects of their operations; to prevent human rights abuses within their sphere of influence and in their own operations; and to use their legitimate influence to support human rights in all countries in which they operate.”

**Appendix 2: Examples of major international CSR initiatives**

*United Nations Set of Multilaterally Agreed Equitable Control of Restrictive Business Practices* – This set of principles, adopted in 1980 by the General Assembly, include in its objectives the protection and promotion of social welfare, in particular those of consumers in developed and developing countries, and the maximisation of international trade benefits to the development of developing countries. It directly addresses enterprises in its chapter on “Principles and rules for enterprises, including transnational corporations”, where it stresses the importance of complying with competition law, and requires enterprises to disclose any information on restrictive arrangements, to refrain from restrictive business practices and abuse of dominant position.

*United Nations Sub-Commission on the Promotion and Protection of Human Rights Norms of Responsibility of Transnational Corporations and Other Business Enterprises in regard to Human Rights*<sup>1</sup> - These rights include: equal opportunity, non-discrimination, security, rights of workers, respect of national sovereignty and human rights, consumer protection, and environmental protection. The norms are accompanied by general provisions for implementation. They include the adoption, dissemination, and implementation of internal rules of operation in compliance with the Human Rights Responsibilities (HRR); the incorporation of the HRR in their contracts with business partners; the periodic evaluations by the enterprises of the impact of their activities on human rights; in case of failure to comply with the HRR, the reparation to those who have been affected; and the independent monitoring by national, international, governmental, and/or nongovernmental mechanisms of the enterprises’ application of the HRR.. The draft norms will be discussed in July and August 2003.

*International Labour Organisation Principles for Multinational Enterprises* - The ILO’s tripartite decision-making body, representing governments, labour organisations and employers organisations, has agreed on the Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy,<sup>2</sup> which aim at creating employment standards for businesses. It covers employment issues such as non-discrimination, security of employment, training, wages, benefits and working conditions, health and safety, freedom of association and the right to organize. It also calls on employers to respect specific international human rights agreements. The Declaration is addressed to workers, unions, governments and businesses. Every three years, the ILO undertakes a survey of the degree of implementation of the Declaration at the national level. The survey faces some criticisms. The methodology is poorly designed, the analysis contains no statistical data that could allow comparison of trends across time, and the report seems to balance the divergent opinions of constituents on the observance of the Declaration in different countries. The ILO is currently trying to address these issues by introducing supplementary and more detailed questionnaires to TNCs and

<sup>1</sup> <http://www1.umn.edu/humanrts/links/NormsApril2003.html>

<sup>2</sup> <http://www.ilo.org/public/english/employment/multi/index.htm>

Global Unions Federation; and by reducing the frequency of the survey to allow for more in-depth national surveys and studies.

*OECD Principles of Corporate Governance* - The OECD plays a prominent role in the fostering of good corporate governance. In 1999, it has produced a revised set of internationally agreed Principles of Corporate Governance,<sup>3</sup> which introduces the concept of corporation's responsibilities towards their stakeholders as well as their shareholders. The Principles are non-binding.

*OECD Guidelines for Multinational Enterprises* - The OECD countries also agreed, in 1976, to a set of Guidelines for Multinational Enterprises,<sup>4</sup> which were revised most recently in 2000, and endorsed by 36 countries.<sup>5</sup> They are the most comprehensive set of multilaterally endorsed guidelines, covering disclosure, employment, industrial relations, environment, bribery, consumer interests, science and technology, competition and taxation. The Guidelines are accompanied by an implementation procedure, with national contact points in each endorsing country, through which complaints can be made and disputes settled between enterprises and other parties. However, the Guidelines are often criticised for not being clear enough on implementation and on who can bring complaints and how. Other related OECD initiatives are under way, including the Bribery Convention and the Guidelines for Consumer Protection in the Context of Electronic Commerce.

*United Nations Global Compact* - The Global Compact (GC), an initiative of the United Nations Secretary General Kofi Annan, seeks to promote development by asking enterprises to adhere to nine principles related to environmental protection, human rights and labour standards in their business operations.<sup>6</sup> These principles are drawn from the Universal Declaration of Human Rights, the ILO's Fundamental Labour Principles, and the Rio Principles on Environment and Development. The Compact involves a network of UN agencies, enterprises, business associations, and civil society organisations. Enterprises are asked to respect and implement the principles; provide the GC with reports of best practice in relation to the principles; and participate in projects with UN agencies and civil society organisations in developing countries. Since January 2003, the 700 enterprises taking part in the Global Compact are required to state in their annual report what they have been doing with respect to all of the nine principles. However, the format and manner of disclosure is left to each enterprise.

*European Union Multi-Stakeholders Forum on CSR* - Since the mid-1990s, the European Parliament has called on several occasions for codes of conduct for the European multinationals operating in developing countries. As a follow-up to the European Council Summit in Lisbon in 2000, the Commission produced a Green Paper in 2001, which launched a debate about the concept of CSR and tried to identify how to build a partnership for the development of a European framework for the promotion of CSR.<sup>7</sup> A Commission Communication was published in July 2002,<sup>8</sup> which forms the basis for a European strategy

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<sup>3</sup> <http://www.oecd.org/pdf/M00008000/M00008299.pdf>

<sup>4</sup> OECD, "The OECD Declaration and decisions on international investment and multinational enterprises: basic texts", 2000.

<sup>5</sup> Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

<sup>6</sup> <http://www.unglobalcompact.org/Portal/>

<sup>7</sup> European Commission, "Promoting a European Framework for Corporate Social Responsibility", 2001.

<sup>8</sup> European Commission, "Corporate Social Responsibility: a business contribution to Sustainable Development", 2002.

on CSR. This strategy recommends “a balanced and broad approach to CSR, including economic, social and environmental issues as well as consumer interests”. The Commission's intention is to focus its strategy not only in Europe but also in developing countries. Following this Communication, a European Multi-Stakeholders Forum on CSR (CSR EMS Forum) was launched on 16 October 2002 and will run until mid-2004.<sup>9</sup> Its major output will be a report to be presented to the Commission, containing results and recommendations for further action. The interest taken by the European Parliament for CSR and the strategy devised by the Commission have potential demonstration effect among European countries. It is likely that the number of schemes will increase, such as the Belgian social labelling scheme, as well as more social performance reporting requirements at the national level.

### Appendix 3 Examples of reporting formats

In order to illustrate the variety of reporting formats, we have compared three examples of the most recent social reports published by Shell, British Petroleum (BP) and The Cooperative Bank. The reason for selecting the first two reports lies in the fact that oil enterprises have been among the first to report on their environmental and social performances, and therefore have many years of experience. Their reports have also been rated among the best social reports in several surveys.<sup>10</sup> These two enterprises' reports illustrate the diversity in reporting formats that can exist within the same industrial sector. The third enterprise has been selected because it allows a comparison across two different sectors, and because it has been judged to be the best social report in the same surveys as the other two enterprises.

The “Shell Report 2002” is articulated around:

Sections	Number of pages (out of a total of 51)
Contents page and links to further information;	1
Introduction	1
Message from the Chairman stating the enterprise's commitment to sustainable development;	1
Summary of the past year's economic, environmental and social performance with a review of the major related achievements and problems;	2
“About Shell” section that includes a statement of the enterprise's strategy and values, a description of management systems in place to integrate sustainability issues in the enterprise's operations, a description of the enterprise's corporate governance, and an explanation of the measurements and external assurance used in the report;	6
Statement by the United Nations Development Programme's Administrator on his perspective of the “energy challenge” accompanied by Shell's response to this challenge;	4
Description of the enterprise's economic, environmental and social performance using Shell's key performance indicators;	26
Assurance section with a message from the auditors – KPMG and PricewaterhouseCoopers - and their report;	1
Basis of reporting	1
Data table containing figures of economic, environmental and social	3

<sup>9</sup> <http://europa.eu.int/comm/enterprise/csr/forum.htm>

<sup>10</sup> Shell has been ranked 2<sup>nd</sup> best sustainability reporter by the ACCA and 6<sup>th</sup> by SustainAbility in 2002. In the latter, BP ranked 7<sup>th</sup> best reporter.

performance over 6 years;	
Statement of Shell's business principles;	1
Contact and publications details.	1

British Petroleum's "Environmental and Social Review 2002" first defines what environmental and social performance encompasses. It includes:

<b>Sections</b>	<b>Number of pages (out of a total of 34)</b>
Contents page and guide to BP's reporting format and principles	1
Group Chief Executive statement that links financial performance to environmental and social performance, highlights major achievements at BP's and outlines the content of the report;	1
Review of the past year including key achievements and major challenges met;	4
Statement of the enterprise's policies regarding ethics, employees, relationships with stakeholders, and health and safety;	4
Section describing the benefits brought by BP to society;	4
Description of issues faced by the enterprise around the world;	6
Selection of information published in local reports;	6
Performance section including safety, environmental, business ethics, employee and social issues;	4
Assurance statement by Ernst & Young;	2
Reference to the enterprise's web site where more detailed performance information can be found.	1
Contact details	1

The Cooperative Bank's "Partnership Report 2002" includes:

<b>Sections</b>	<b>Number of pages (out of a total of 102)</b>
List of the various social, ethical and environmental awards and commendations received by the enterprise in 2002	1
Contents page	1
Chief Executive Statement	6
Performance review including data on delivering value, social responsibility, and ecological sustainability over time periods of 2 to 6 years depending on the indicator	3
Background and historical perspective of the enterprise's "partnership approach"	6
Description of the enterprise's stakeholders, their priorities and performance measures used	2
A guide to the symbols and indicators used in the report	5
Performance on delivering value	18
Performance on social responsibility	19
Performance on ecological sustainability	19

Review of campaigns to which the enterprise participates	6
Auditor's statement by "ethics etc...2, assessment of delivering value by "Tomorrow's Enterprise", assessment of social responsibility by "Business in the Community", and assessment of ecological sustainability by "The Natural Step UK"	5
Social, ethical and environmental awards and commendations received in the period January–April 2003	1

#### Appendix 4 Additional information on the current state of sustainability reporting

##### A. Trends

Surveys of reporters carried out by major accounting companies and consultancies show an increase in triple bottom line reporting, with environmental issues still largely more reported on than other sustainability issues. KPMG's survey of the world's top 250 companies ranked by revenue<sup>11</sup> (GFT250) shows that 45% published a separate sustainability report in 2002 compared to 35% in 1999. For the survey of the Top 100 companies in 19 countries, these figures are respectively 28% and 24%.

Although Health and Safety, and Environmental reporting are still the most prominent types of reports among GFT250 companies (73%), other types of reports are emerging including TLB reports (14%), combined environmental and social reports (10%), and social and combined social and financial reports (3%). The Top 100 survey mirrors this trend, showing that these companies are increasingly incorporating social and economic issues to their Health and Safety, and Environmental reports.<sup>12</sup> Social issues that are increasingly focused on include community involvement, equal opportunity, workforce diversity, human rights, supplier relations, child labour, freedom of association, and fair trade.

The reporting rates tend to be higher in countries with large corporations. Across surveys, the United States, United Kingdom, Germany and Japan are consistently ranked within the top 5 countries with the largest number of sustainability reports.

##### Corporate reporting by country

	<b>CorporateRegister.com</b>	<b>KPMG GFT250</b>	<b>KPMG Top 100</b>
1	United Kingdom	United States	Japan
2	Germany	Japan	United Kingdom
3	United States	Germany	United States
4	Japan	United Kingdom	The Netherlands
5	Australia	France	Germany

The result of the Top 100 companies is particularly interesting as it compares the same number of companies in each country. In this survey, Japan has by far the highest proportion of companies producing separate corporate reports.

<sup>11</sup> Global Fortune Top 250 or GFT250

<sup>12</sup> KPMG, "International Survey of Corporate Sustainability Reporting", 2002.

Sustainability reporting rates by country

Japan	72%
United Kingdom	49%
United States	36%
The Netherlands	35%
Germany	32%

Source: KPMG Top 100

Sustainability reporting practices are no longer restricted to sectors with a high environmental impact in Western countries, but also in non-industrial sectors and other regions. KPMG's GFT250 survey shows that the largest increase in reporting rates occur in the Food & beverages (+30%), Communication & media (+21%), Transport (+20%), and Utilities (+18%) sectors. However, the Chemicals & synthetics, Forestry & paper, and Oil & gas, are still amongst the highest sustainability reporting rates across all surveys.

Corporate reporting by sector

	CorporateRegister.com	KPMG GFT250	KPMG Top 100
1	Chemicals	Mining	Utilities
2	Electricity	Forestry, pulp & paper	Communication & media
3	Oil & Gas	Chemicals & synthetics	Chemicals & synthetics
4	Transport	Transport	Forestry, pulp & paper
5	Forestry & Paper	Pharmaceuticals	Oil & gas

**B. Content**

All surveys agree on the fact that the content and quality of sustainability reports and vary greatly. Content is generally analysed in term of environmental, economic and social issues.

Environmental performance

Environmental issues include the impact of production processes, products and services on air, land, biodiversity, and human health.

Economic performance

Economic performance reporting spans wages and benefits, productivity, job creation, outsourcing expenditures, R&D investments, and investments in training and other forms of human capital<sup>14</sup>.

Social performance

Social issues typically include traditional reporting topics such as workplace health and safety, employee satisfaction, and corporate philanthropy, as well as more external topics such as labour and human rights, diversity of the workforce, and supplier relations. The following table shows that traditional reporting topics still rate higher than the newer topics.

### Social topics addresses in GFT250 reports

Topics	(%)
Community involvement	97
Health and safety	91
Equal opportunity / workforce diversity	88
Employee satisfaction	67
Human rights	55
Supplier relations	39
Child labour	36
Freedom of association	27
Fair trade / international development	18
Corruption	15

Source: KPMG

PwC notes that in this area, the standards are evolving, and the tools and metrics vary by geography and industry.

PwC's survey of 140 large US based companies<sup>13</sup> shows that companies are struggling to define what sustainability means to their business and to translate sustainability to measurable standards. Overall, the ability to develop and use concrete metrics to show sustainable improvements are significantly lower in the areas of social and environmental performance than in economic performance.<sup>14</sup>

Sustainability has carried out a quality assessment of 100 sustainability and CSR reports from around the world and concludes that, although the average number of pages has increased by 45%, the report's quality has not increased compared to the quality level in 2000.<sup>15</sup>

Companies have started developing sets of social indicators in order to be able to measure their social performance and set targets. The table below ranks the top 5 social performance indicators used by the GFT250 companies. For those social issues for which it is more difficult to set a hard performance metric, the reporting remains qualitative.

#### Top 5 social performance indicators

Topics	(%)
Accident / injury frequency	76
Community spending	48
Women in staff / management	42
Staff diversity	27
Supplier diversity	12

Source: KPMG GFT250

#### Other contents

Increasingly, companies report on stakeholder dialogue, by including stakeholder statements, staff surveys, community panels and forums. When specific stakeholders are mentioned, they include mainly employees, customers, shareholders and society/community. Codes of conduct

<sup>13</sup> PricewaterhouseCoopers, "Sustainability Survey Report", 2002.

<sup>14</sup> PricewaterhouseCoopers, "Management Barometer Survey", September 2002.

<sup>15</sup> SustainAbility, "Trust Us", 2002.

are also referred to, and partnerships with NGOs are referred to nearly as many times (40%) as partnerships with other businesses (56%).<sup>12</sup>

### C. Verification

Despite the lack of internationally accepted standards for providing assurance on social and environmental reports, a significant number of reports were verified in 2002 by a third party – respectively 29% and 27% for GFT250 and Top 100 companies. Verification was made by a major accountancy firm in 65% of cases.<sup>12</sup>

#### Useful websites

	<b>Organization</b>	<b>Web address</b>
1	Active Citizenship Network	<a href="http://www.activecitizenship.net">http://www.activecitizenship.net</a>
2	Amnesty International	<a href="http://www.amnesty.org">http://www.amnesty.org</a>
3	Business and Sustainable Development	<a href="http://www.bsdglobal.com/issues/reporting.asp">http://www.bsdglobal.com/issues/reporting.asp</a>
4	Business for Social Responsibility	<a href="http://www.bsr.org">http://www.bsr.org</a>
5	Business Impact	<a href="http://www.business-impact.org/bi2/front/index.cfm">http://www.business-impact.org/bi2/front/index.cfm</a>
6	Business in the Community	<a href="http://www.bitc.org.uk">http://www.bitc.org.uk</a>
7	California Global Corporate Accountability Project	<a href="http://www.nautilus.org/cap/index.html">http://www.nautilus.org/cap/index.html</a>
8	Calvert Group	<a href="http://www.calvert.com/sri.html">http://www.calvert.com/sri.html</a>
9	Caux Round Table	<a href="http://www.cauxroundtable.org">http://www.cauxroundtable.org</a>
10	Center for Corporate Citizenship at Boston College	<a href="http://www.bc.edu/centers/ccc/index.html">http://www.bc.edu/centers/ccc/index.html</a>
11	Center for Ethical Business Culture	<a href="http://www.cebcglobal.org">http://www.cebcglobal.org</a>
12	Centre for Innovation in Corporate Responsibility	<a href="http://www.cicr.net/">http://www.cicr.net/</a>
13	Centre for Science and Environment	<a href="http://www.cseindia.org/">http://www.cseindia.org/</a>
14	Centre for Social and Environmental Accounting Research	<a href="http://www.gla.ac.uk/departments/accounting/csear/">http://www.gla.ac.uk/departments/accounting/csear/</a>
15	Centre of Research on Multinational Corporations	<a href="http://www.somo.nl/index_eng.html">http://www.somo.nl/index_eng.html</a>
16	Clean Clothes Campaign	<a href="http://www.cleanclothes.org/">http://www.cleanclothes.org/</a>
17	Coalition for Environmentally Responsible Economies	<a href="http://www.ceres.org">http://www.ceres.org</a>
18	Conference Board	<a href="http://www.conference-board.org/knowledge/citizenship.cfm">http://www.conference-board.org/knowledge/citizenship.cfm</a>
19	Corporate Watch	<a href="http://www.corpwatch.org/">http://www.corpwatch.org/</a>
20	Covalence S.A.	<a href="http://www.covalence.ch/">http://www.covalence.ch/</a>
21	CSR Europe	<a href="http://www.csreurope.org">http://www.csreurope.org</a>
22	Domini Social Investments	<a href="http://www.domini.com">http://www.domini.com</a>
23	Dow Jones	<a href="http://www.sustainability-indexes.com">http://www.sustainability-indexes.com</a>
24	Ecumenical Council for Corporate Responsibility	<a href="http://www.eccr.org.uk/">http://www.eccr.org.uk/</a>
25	Empresa	<a href="http://www.empresa.org/english/">http://www.empresa.org/english/</a>
26	Ethical Investment Research Service	<a href="http://www.eiris.org">http://www.eiris.org</a>
27	Ethical Trading Initiative	<a href="http://www.ethicaltrade.org">http://www.ethicaltrade.org</a>

28	EU CSR web site	<a href="http://europa.eu.int/comm/employment_social/soc-dial/csr/csr_index.htm">europa.eu.int/comm/employment_social/soc-dial/csr/csr_index.htm</a>
29	European Federation of Accountants	<a href="http://www.fee.be/">www.fee.be/</a>
30	European Multi-Stakeholder Forum on Corporate Social Responsibility	<a href="http://forum.europa.eu.int/irc/empl/csr_eu_multi_stakeholder_forum/info/data/en/csr%20ems%20forum.htm">forum.europa.eu.int/irc/empl/csr_eu_multi_stakeholder_forum/info/data/en/csr%20ems%20forum.htm</a>
31	Fair Labour Association	<a href="http://www.fairlabor.org/">www.fairlabor.org/</a>
32	Forest Stewardship Council	<a href="http://www.fscoax.org/">www.fscoax.org/</a>
33	Friends of the Earth International	<a href="http://www.foei.org">www.foei.org</a>
34	Global Alliance for Workers and Communities	<a href="http://www.theglobalalliance.org/main.cfm">www.theglobalalliance.org/main.cfm</a>
35	Global Compact	<a href="http://www.unglobalcompact.org">www.unglobalcompact.org</a>
36	Global Corporate Governance Forum	<a href="http://www.gcgf.org/">www.gcgf.org/</a>
37	Global Mining Initiative	<a href="http://www.globalmining.com/index.asp">www.globalmining.com/index.asp</a>
38	Global Reporting Initiative	<a href="http://www.globalreporting.org">www.globalreporting.org</a>
39	Global Responsibility International AB	<a href="http://www.global-responsibility.com">www.global-responsibility.com</a>
40	Global Sullivan Principles of Social Responsibility	<a href="http://globalsullivanprinciples.org/index.htm.htm">globalsullivanprinciples.org/index.htm.htm</a>
41	GoodCorporation	<a href="http://www.goodcorporation.com/en/">www.goodcorporation.com/en/</a>
42	Institute of Social and Ethical Accountability	<a href="http://www.accountability.org.uk/">www.accountability.org.uk/</a>
43	Interfaith Center on Corporate Responsibility	<a href="http://www.iccr.org/">www.iccr.org/</a>
44	International Business Leaders Forum	<a href="http://www.pwblf.org">www.pwblf.org</a>
45	International Institute for Environment and Development	<a href="http://www.ied.org/cred/index.html">www.ied.org/cred/index.html</a>
46	International Institute for Sustainable Development	<a href="http://www.iisd.org/measure/default.htm">www.iisd.org/measure/default.htm</a>
47	International Labour Organisation	<a href="http://www.ilo.org">www.ilo.org</a>
48	International Sustainability Indicators Network	<a href="http://www.sustainabilityindicators.org/">www.sustainabilityindicators.org/</a>
49	Investor Responsibility Research Center	<a href="http://www.irrc.org">www.irrc.org</a>
50	Keidanren Charter for Good Corporate Behavior	<a href="http://www.keidanren.or.jp">www.keidanren.or.jp</a>
51	Kenan Institute	<a href="http://www.kenaninstitute.unc.edu/Affiliates/KIinWash/KIW_CSR/KIW_CSR.html">www.kenaninstitute.unc.edu/Affiliates/KIinWash/KIW_CSR/KIW_CSR.html</a>
52	Marine Stewardship Council	<a href="http://www.msc.org/">www.msc.org/</a>
53	MHC International Limited	<a href="http://www.mhcinternational.com/">www.mhcinternational.com/</a>
54	Natural Heritage Institute	<a href="http://www.n-h-i.org/Contact/contact.html">www.n-h-i.org/Contact/contact.html</a>
55	Nautilus Institute for Security and Sustainability	<a href="http://www.nautilus.org/index.html">www.nautilus.org/index.html</a>
56	New Economics Foundation	<a href="http://www.neweconomics.org/default.asp">www.neweconomics.org/default.asp</a>
57	OECD	<a href="http://www.oecd.org/EN/home/0,,EN-home-126-nodirectorate-no-no-no-28,00.html">www.oecd.org/EN/home/0,,EN-home-126-nodirectorate-no-no-no-28,00.html</a>
58	Oekom Research	<a href="http://www.oekom.de/ag/english/">www.oekom.de/ag/english/</a>
59	Social Accountability International	<a href="http://www.cepaa.org/AboutSAI/AboutSAI.htm">www.cepaa.org/AboutSAI/AboutSAI.htm</a>
60	Social Investment Forum	<a href="http://www.socialinvest.org">www.socialinvest.org</a>
61	Social Venture Network	<a href="http://www.svn.org">www.svn.org</a>
62	SocialFunds.com	<a href="http://www.socialfunds.com">www.socialfunds.com</a>

63	Stakeholder Alliance	<a href="http://www.stakeholderalliance.org/sunstds.html">www.stakeholderalliance.org/sunstds.html</a>
64	Stratos	<a href="http://www.stratos-sts.com/index.htm">www.stratos-sts.com/index.htm</a>
65	SustainAbility	<a href="http://www.sustainability.com">www.sustainability.com</a>
66	Taskforce on the Churches and Corporate Responsibility	<a href="http://www.web.net/~tccr/benchmarks/http://www.web">www.web.net/~tccr/benchmarks/http://www.web</a>
67	The Copenhagen Centre	<a href="http://www.copenhagencentre.org">www.copenhagencentre.org</a>
68	Transparency International	<a href="http://www.transparency.org/">www.transparency.org/</a>
69	Triple-P Performance Centre	<a href="http://www.triple-p.org">www.triple-p.org</a>
70	United Nations Global Compact	<a href="http://www.unglobalcompact.org/Portal/">www.unglobalcompact.org/Portal/</a>
71	United Nations Research Institute for Social Development	<a href="http://www.unrisd.org/">www.unrisd.org/</a>
72	University of Victoria	<a href="http://web.uvic.ca/sci/">web.uvic.ca/sci/</a>
73	World Bank Corporate Social Responsibility Practice	<a href="http://www.worldbank.org/privatesector/csr/index.h">www.worldbank.org/privatesector/csr/index.h</a>
74	World Business Council for Sustainable Development	<a href="http://www.wbcsd.ch">www.wbcsd.ch</a>
75	World CSR	<a href="http://www.worldcsr.com/pages/">www.worldcsr.com/pages/</a>
76	World Economic Forum	<a href="http://www.weforum.org/site/homepublic.nsf/Content">www.weforum.org/site/homepublic.nsf/Content</a>
77	Worldwide Responsible Apparel Production	<a href="http://www.wrapapparel.org/">www.wrapapparel.org/</a>

## Notes

- <sup>1</sup> The 800 largest non-financial enterprises in the world influence 50 per cent of the world's product. Estimation from the Swiss Observatoire de la Finance. <http://www.obsfin.ch>
- <sup>2</sup> ActionAid, "Unlimited companies", 2003.
- <sup>3</sup> [http://www.doc.mmu.ac.uk/aric/ae/Sustainability/Older/Brundtland\\_Report.html](http://www.doc.mmu.ac.uk/aric/ae/Sustainability/Older/Brundtland_Report.html)
- <sup>4</sup> <http://www.un.org/esa/sustdev/documents/agenda21/english/agenda21toc.htm>
- <sup>5</sup> UNEP/Sustainability/Business Case, "Buried Treasure: Uncovering the business case for corporate sustainability", 2001.
- <sup>6</sup> Ibid.
- <sup>7</sup> This survey, carried out in early 2003 by the World Business Council for Sustainable Development on behalf of the United Nations Global Compact, has not yet been published.
- <sup>8</sup> OECD, "Codes of Corporate Conduct: A Review of Their Contents", 2001. This review of 246 codes shows a great variety of content and degree of details in codes of conduct.
- <sup>9</sup> UNRISD, "Voluntary Approaches to Corporate Responsibility", 2002.
- <sup>10</sup> OECD, "Making Codes of Corporate Conduct Work: Management Control Systems and Corporate Responsibility", 2001.
- <sup>11</sup> Ibid.
- <sup>12</sup> This chapter largely derives from the International Institute for Environment and Development (IIED)'s report on "Legal Issues in Corporate Citizenship", 2003.
- <sup>13</sup> The main ones include the ILO Labour Conventions, the Basel Convention on Hazardous Waste Disposal, the Convention on Biological Diversity, the Montreal Protocol on Substances that Deplete the Ozone Layer, the Vienna Convention for the Protection of the Ozone Layer and the United Nations Convention to Combat Desertification.
- <sup>14</sup> <http://www.oecd.org/EN/document/0,,EN-document-28-nodirectorate-no-11-37318-28,00.html>
- <sup>15</sup> See Loi visant à promouvoir la production socialement responsable. Available at [http://www.cass.be/cgi\\_loi/legislation.pl](http://www.cass.be/cgi_loi/legislation.pl)
- <sup>16</sup> [http://www.dgcl.interieur.gouv.fr/bases\\_juridiques/bilan\\_social/accueil\\_bilan\\_social.html](http://www.dgcl.interieur.gouv.fr/bases_juridiques/bilan_social/accueil_bilan_social.html)
- <sup>17</sup> [http://www.bnb.be/BA/F/P1\\_00.htm](http://www.bnb.be/BA/F/P1_00.htm)
- <sup>18</sup> P. Scott, "Reporting all over the world", *Environmental Finance*, December 2000-January 2001, pp. 36-37.
- <sup>19</sup> UK Department of Trade and Industry (DTI), "Modern Company Law: Final Report", 2001. Available at [http://www.dti.gov.uk/cld/final\\_report/index.htm](http://www.dti.gov.uk/cld/final_report/index.htm)
- <sup>20</sup> [http://www.hmso.gov.uk/acts/acts1995/Ukpga\\_19950026\\_en\\_1.htm](http://www.hmso.gov.uk/acts/acts1995/Ukpga_19950026_en_1.htm)
- <sup>21</sup> Other major works on corporate governance include the Report of the Cadbury Committee on the Financial Aspects of Corporate Governance, the King Report on Corporate Governance for South Africa and the Commonwealth Association for Corporate Governance Guidelines.
- <sup>22</sup> OECD, "OECD Principles of Corporate Governance", 1999.
- <sup>23</sup> IPPR, "What's on the agenda? How UK directors contribute to social and environmental objectives", 2002. Available at <http://www.ippr.org/publications/index.php?book=318>
- <sup>24</sup> <http://www.combinet.net/governance/finalver/cacg.htm>
- <sup>25</sup> <http://www.cliffedekker.co.za/literature/corpgov/index.htm>
- <sup>26</sup> <http://www.shareholder.com/visitors/dynamicdoc/document.cfm?CompanyID=ASX&DocumentID=364&pagenum=1&keyword=Type%20keyword%20here>
- <sup>27</sup> [http://www.nyse.com/pdfs/corp\\_recommendations\\_nyse.pdf](http://www.nyse.com/pdfs/corp_recommendations_nyse.pdf)
- <sup>28</sup> "International Right To Know: Empowering Communities Through Corporate Transparency", AFL-CIO, Amnesty International USA, EarthRights International, Friends of the Earth, Global Exchange, Oxfam America, Sierra Club, Working Group on Community Right to Know, 2003. Available at <http://www.irtk.org/irtkreport.pdf>
- <sup>29</sup> "Fostering Growth and Promoting a Responsible Market Economy: A G8 Declaration", 2003, Evian. Available at <http://www.g7.utoronto.ca/summit/2003evian/growth.html>
- <sup>30</sup> <http://www.publishwhatyoupay.org>
- <sup>31</sup> Institute of Business Ethics, "Does Business Ethics Pay?", 2003.
- <sup>32</sup> <http://www.domini.com/Social-Screening/Non-US-Operations/index.htm>
- <sup>33</sup> <http://www.sustainability-indexes.com>
- <sup>34</sup> J. Fuller, "Banking on a good reputation", FTfm 21 July 2003, p. 6.
- <sup>35</sup> Investment assets residing in professionally managed portfolios utilising one of more of the following investment strategies: screening, shareholder advocacy and community investing.
- <sup>36</sup> Social Investment Forum, "Report on socially responsible investing trend in the United States", 2001.
- <sup>37</sup> M. Kiernan, "Making SRI mainstream", 2003.

- <sup>38</sup> <http://www.socialfunds.com/education/index.cgi>
- <sup>39</sup> <http://www.foe.org/international/shareholder/index.html>
- <sup>40</sup> See <http://www.socialfunds.com/news/print.cgi?sfArticleId=982>
- <sup>41</sup> Crédit Lyonnais, Credit Suisse First Boston, Westpac Banking Corporation, Rabobank and HVB.
- <sup>42</sup> D. Sevastopulo, "Banks adopt 'Equator Principles'", *Financial Times*, 4 June 2003.
- <sup>43</sup> R. Gray, "Current developments and trends in social and environmental auditing, reporting and attestation: A personal perspective", 2000.
- <sup>44</sup> KPMG, "International Survey of Environmental Reporting 1996", 1997.
- <sup>45</sup> KPMG, "International Survey of Corporate Sustainability Reporting", 2002.
- <sup>46</sup> SustainAbility/UNEP, "Trust Us: The Global Reporters 2002 Survey of Corporate Sustainability Reporting", 2002.
- <sup>47</sup> A number of assessments of social reports have been carried out by KPMG, UNEP/SustainAbility, ACCA, PricewaterhouseCoopers and others. See bibliography.
- <sup>48</sup> SustainAbility/UNEP, "Trust Us: The Global Reporters 2002 Survey of Corporate Sustainability Reporting", 2002.
- <sup>49</sup> According to KPMG's survey, social topics are addressed at the following rates in GFT250 reports: community involvement, 97%; health and safety, 91%; equal opportunity/workforce diversity, 88%; employee satisfaction, 67%; human rights, 55%; supplier relations, 39%; child labour, 36%; freedom of association, 27%; fair trade/international development, 18%; corruption, 15%.
- <sup>50</sup> KPMG, "International Survey of Corporate Sustainability Reporting", 2002.
- <sup>51</sup> Ibid.
- <sup>52</sup> Investors Relations Society, <http://www.ir-soc.org.uk>
- <sup>53</sup> <http://www.globalreporting.org/>
- <sup>54</sup> By way of comparison, an SME seeking a public listing in Germany would have to pay at least US\$100,000 to produce the necessary financial information, most of which would already be in its books. If SMEs had to start to collect non-financial information as well, the costs could be prohibitive, particularly since no methodology is yet agreed and companies are left to themselves to compile and report their indicators.
- <sup>55</sup> Organizations that wish to identify their report as prepared in accordance with the 2002 GRI Guidelines must meet five conditions:
1. Report on the numbered elements in Sections 1 to 3 of Part C.
  2. Include a GRI Content Index as specified in Section 4 of Part C.
  3. Respond to each core indicator in Section 5 of Part C by either (a) reporting on the indicator or (b) explaining the reason for the omission of each indicator.
  4. Ensure that the report is consistent with the principles in Part B of the Guidelines.
  5. Include the following statement signed by the board or CEO: "This report has been prepared in accordance with the 2002 GRI Guidelines. It represents a balanced and reasonable presentation of our organisation's economic, environmental, and social performance."
- <sup>56</sup> <http://www.wbcsd.ch/templates/TemplateWBCSD4/layout.asp?MenuID=1>
- <sup>57</sup> <http://www2.bitc.org.uk/index.html>
- <sup>58</sup> <http://www.accountability.org.uk/>
- <sup>59</sup> [http://www.ivis.co.uk/pages/gdsc7\\_1.PDF](http://www.ivis.co.uk/pages/gdsc7_1.PDF)
- <sup>60</sup> FEE, "Discussion Paper Providing Assurance on Sustainability Reports", 2002. Available from <http://www.fee.be/publications/main.htm>
- <sup>61</sup> Environmental Resources Management (ERM), "Corporate social reporting survey", 2002. <http://www.erm.com/ERM/news.nsf/AllByID/8A88D6D0AA0451B880256C3900309CBD?OpenDocument>

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# **CHAPTER VIII**

## **REVISED MODEL ACCOUNTING CURRICULUM**

### **GLOBAL CURRICULUM FOR THE PROFESSIONAL EDUCATION OF PROFESSIONAL ACCOUNTANTS**

#### **SUMMARY OF DISCUSSIONS**

An UNCTAD resource person provided background information on the work of the Group of Experts on a revised Model Curriculum (MC) for professional education of professional accountants and presented a semi-final draft of the MC (TD/B/COM.2/ISAR/21).

Concern was raised regarding the fact that the revised MC still adhered solely to the input approach. Although the output or competency-based approach was still at an early stage, it had gained users over the past four years, and a number of professional associations were using it, including the Canadian Institute of Chartered Accountants. The choice had been made not to use this approach in the revised MC, as its implementation still posed problems in certain member States. It was agreed that an annex should be added to the revised MC to acknowledge that the input approach was not the only approach and to give information on the output approach. A participant proposed that the MC be documented in a matrix form comparing it to the competency approach, as is already done in some schools.

Several participants raised the issue of education for lower-level accountants. The current version of the MC focused on the education of professional accountants. Although it was not intended for the training of middle-level accountants, technicians or middle-level bookkeepers, several speakers argued that direction should be given to potential users wanting to use the MC as a basis for training lower-level accountants.

A participant mentioned as a downside the fact that the revised MC did not emphasize the form that training should take. It was agreed that designing a MC was not sufficient and that ISAR go a step further when implementing the MC. However, it was stressed that this was beyond the minimum revision agreed to by ISAR members in 2002. The question was raised as to whether ISAR had a role in moving forward from the design stage to implementation.

Several participants were concerned that there was not enough emphasis on bringing all accounting practices into line with international standards. It was argued that a specific course covering the understanding and application of international standards should be added. In response, it was highlighted that the revised MC was fully in line with international accounting standards, which were integrated into all relevant modules, and with the IFAC Education Committee's new education standards. The revised MC was a living document and would be modified to reflect changes in IFAC pronouncements. A participant suggested that the MC be approved and after that be revised every year, based on the experience of countries having implemented it.

A participant argued that professional accountants should know and be able to understand the economics of an enterprise as a whole. For this reason, the revised MC should include topics such as financial and economic analysis of the performance of enterprises. The example of the Russian Federation was given, where financial accounting courses included financial analysis, and management accounting courses covered analysis of economic activities, in order to allow proper decision making when managing an enterprise. In response, it was pointed out that the MC was a list of topics, not a full syllabus. When the MC is translated into a syllabus, financial analysis and economic analysis should be added as part of an existing module.

A participant stressed the importance of accounting internships and suggested that it become a core module, as it would motivate educational institutions to make more of an effort to furnish the necessary premises and material and to establish relationships with companies interested in taking interns. In response, it was said that this issue had been debated at length in previous discussions and it had been agreed that internship could not be a core module, as this MC was designed for professional training, which could be provided by entities other than academic institutions. It was also suggested that the MC be subjected to employers' comments.

Several participants stressed the importance of the application of theory. The profession lacked practical examples because those tended to be specific to societies. It was suggested that practical examples be devised and compiled in a document that could be used by teachers to provide examples to students.

A participant suggested that it would be useful to find out which countries used the MC, which was first issued in 1999, and draw lessons from their experience. This suggestion was well received, and an UNCTAD resource person noted that, according to a survey completed in 2002, some 20 countries were using the MC or were considering its use in their professional qualification requirements. A representative from Thailand said that the MC had been used in revising the Thai curriculum nationwide.

Various requests were made for changes in the MC, including the following: Statement of changes in equity should be incorporated into module 3.17; module 1.3 on organizational behaviour should include human resources; module 3.8 on auditing fundamentals should cover internal as well as external auditing, as the standards are different; modules on management accounting and costing should also cover activity-based costing; the IT module should cover the Enterprise Resource Planning (ERP) and SAP software packages; modules on organization and business knowledge should cover personality development and stress management; disclosures in notes to financial statements should be covered in the MC; module 3.10 on knowledge integration should integrate technical knowledge, with real case problems on financial analysis and strategy; the law modules should cover security laws.

It was suggested that a programme similar to that of the United Nations Development Programme (UNDP) on the enhancement and evaluation of universities in Arabic speaking countries should be put in place, in order to help bodies using the MC around the world to implement it. It was pointed out that the revised MC focused mainly on private-sector work and should also emphasize other components of society, such as public-sector enterprises, as these had a different structure.

ISAR requested the UNCTAD secretariat to continue its efforts on national and international requirements for the qualification of professional accountants in coordination with the Steering Committee on International Professional Qualifications and the Education Committee of the International Federation of Accountants (IFAC). It also requested that the secretariat finalize the Model Curriculum and disseminate it as widely as possible.

## **INTRODUCTION**

The following model curriculum is a revision of the curriculum that was developed in 1999 by UNCTAD, together with experts from the Arab Society of Certified Accountants, the Association of Chartered Certified Accountants, the Certified General Accountants of Canada, the European Commission, FIDEF, the Institute of Chartered Accountants of Scotland, the Polish Accounting Standards Board, the International Federation of Accountants, and representatives from academia and international accounting firms acting in their personal capacities (publication reference: UNCTAD/ITE/EDS/9). The purpose of the detailed curriculum is to describe for the international community the technical subject areas that an individual must master to become a professional accountant.

The detailed curriculum is only one part of a larger exercise to create a benchmark for the qualifications of professional accountants which if followed would enable them to better function in and to better serve the global economy. The components of such a system include:

- (a) general knowledge and skills;
- (b) professional (technical) education;
- (c) professional examinations;
- (d) practical experience;
- (e) continuing professional education; and
- (f) a certification scheme.

All these are described in the UN/UNCTAD document TD/B/COM.2/ISAR/5, entitled "Development of a global accounting curriculum and other qualification requirements".

The benchmark was developed for the international community as a whole in order to promote global harmonization of professional qualification requirements. Such harmonization would close the gaps in national training systems, cut the cost of mutual recognition agreements and increase trans-border trade in accountancy services. While there are international standards for the provision of the service of accounting, there are no global standards for the service providers.

To see the curriculum in the proper perspective, it should be read with five caveats in mind. First, The MC is for the formal education of professional accountants at the highest level in every country of the world – not just for developing countries. Many

education/training institutions, however, are not capable or ready to adopt/adapt the MC. Therefore; certain pre-conditions have to exist before an institution embarks on an implementation program.

Second, the detailed curriculum is intended to serve as a guide to the technical content of the education/training of the professional accountant. It should be distinguished from the basic general knowledge, skills and practical experience that aspirants also need to function in an interdependent economy. It is not sufficient for persons aspiring to become professional accountants to possess only theoretical knowledge. Accountants must be able to apply the theoretical knowledge in practical, real-life situations by obtaining, analyzing, interpreting, synthesizing, evaluating and communicating information. Many believe that these skills are best acquired during a period of general education, prior to and integrated into professional education. It should also be recognized that individuals obtain general knowledge, skills, and practical experience through a) an education program with an internship component, b) a required period of practical experience after graduation, and c) a continuing education program during their professional careers. Supervised and mentored practical training can, if clear education objectives are formulated, complement theoretical higher education.

Third, there are a number of approaches to global accounting education. One approach is prescriptive and specifies the general and technical education professional accountants need to develop the required skills. It is best thought of as an “input” approach. Another approach is the competency-based approach, where competency is defined as the ability to perform activities within an occupation or function to the standards expected in employment. It then specifies what basic competencies professional accountants need. It looks at competencies as “outputs” or “outcomes” and then works backwards to specify the education necessary to achieve these “outcomes”. Even though the competency approach in professional education is progressing in many countries, the process and the outcomes are still in their early stages. The experts, therefore, have chosen the more traditional approach, that is, to develop a curriculum for accounting education rather than to follow a competency-based approach. The choice of the input approach was also influenced by the fact that developing countries had asked for explicit guidance on curricula and that the latter might be more easily implemented than a competency-based system. The 2003-revised edition of the MC still adheres to the input approach.

Fourth, since the detailed curriculum is merely the starting point for a country desiring to harmonize its educational system to meet global requirements, the input approach, on which the MC is built, can be reconciled with the competency-based approach in the implementation process, if so desired. To do so, an institution/country need to start the implementation process by: a) determining the desired qualitative features of its accounting professionals to function successfully in its specific environment; b) developing an institution-specific mission considering prevailing academic and professional infrastructures and existing strength and challenges, c) examining the contents of existing courses against the MC to decide how relevant existing courses are in serving local needs and constituencies, d) developing a matrix to integrate needed skills with technical and professional content of the MC e) incorporating appropriate assessment methodologies e) converting the MC modules into courses and/or training programs and deciding on course identification and sequence, f) developing corresponding syllabuses and determining time to be spent on each course, and finally g) assessing outcomes.

Fifth, and lastly, the MC is a living document. It should be changed as needed to ensure compliance with IFAC's IES and to reflect new developments in professional, technical, and economic issues as well as updates in technology.

It should be mentioned that the detailed curriculum was developed after a review of seven national curricula. It is thus based on existing international guidance and the curricula of selected professional organizations, which are known for their high quality. The major headings for the various modules are grouped under classifications contained in the International Federation of Accountants' (IFAC) *Pre-qualification Education, Assessment of Professional Competence and Experience Requirements of Professional Accountants, International Educational Guideline* (IEG) No. 9 (revised 1996) and *Information Technology in the Accounting Curriculum*, IEG No. 11 (revised 1998)\*. UNCTAD also relied heavily on the curriculum of the Association of Chartered Certified Accountants and that of the Certified General Accountants of Canada. These were supplemented with selected items that were identified in UNCTAD's review of the curricula of other national organizations. UNCTAD wishes to extend its thanks to these professional organizations for allowing portions of their curricula to be included.

## **1. Organizational And Business Knowledge**

### **1.1. Module on economics**

The objective of this module is to provide candidates with an understanding of the issues, concepts and theories of microeconomics and macroeconomic. Accounting is concerned with the identification, measurement, and communication of data revealing socio-economic activities of an entity for the purpose of facilitating decision making by all interested parties in their effort to efficiently and effectively allocate their scarce resources. Economic data is the primary input for the accounting functions. It is imperative, therefore, for accountants to thoroughly understand the field of economics. In this module, students learn some analytical and critical thinking tools used by economists and are provided with opportunity to practice their use. This includes the practical application of economic reasoning for forecasting and solving problems in business, industry, and government. Individuals are expected to have an understanding of how their national economy functions, as well as how other national economies function. They should also understand how their national economy interacts with the global economy and appreciate the importance of international trade, and the effects of changes in foreign exchange rates and balances of payments in the performance of the business. On completion of this module the individual should be able to:

- demonstrate a solid knowledge of the vocabulary associated with the principles of macro and microeconomics.
- demonstrate a basic understanding of the theories associated with the principles of macro and microeconomics.
- evaluate world trade activities and government policy with respect to economics.
- better comprehend economic and financial events and identify how they affect the environment of accounting.

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\* Currently being converted by IFAC Education Committee into International Education Standards for Professional Accountants

- have a solid foundation which will enable them to understand and recognize the nature of economic events and their impact on accounting functions.
- have an understanding of the role of accounting in a market-based economy
- have a grasp of the free enterprise system and the role of the financial market in the global economy.

### **1.1.1 Economics questions, economic methods and the market**

- (a) Basic economic issues, emphasizing the fundamental problem in economics which is the concept of scarcity, i.e. since resources (financial, material, time, etc.) are scarce, individuals as well as organizations are forced to make choices thus creating economic events.
- (b) The function and working parts of the nation's economy
- (c) Main alternative economic systems in the world
- (d) Economic theories and models, including: models of relationships between economic variables at the micro and macro economic levels; the types of economic models; and mathematical and statistical techniques used in constructing economic models
- (e) Property rights and money
- (f) Demand and changes in demand
- (g) Supply and changes in supply
- (h) Price determination
- (i) Communicating economic data using graphs

### **1.1.2 Elasticity, price regulation and consumer choice**

- (a) Price elasticity of demand
- (b) Other elasticities of demand
- (c) Elasticity of supply
- (d) Price regulation
- (e) Choices that consumers make
- (f) Utility and utility maximization
- (g) Consumer surplus
- (h) Formulas and equations used in economics
- (i) Forecasting: the use of objective data and subjective judgment to assess the future values of certain economic factors; and demand forecasting

### **1.1.3 Production and the enterprise's economic policies**

- (a) The enterprise's economic problems
- (b) Elementary business finance
- (c) Historical costs and opportunity costs as economic concepts
- (d) The efficiency of enterprises
- (e) The enterprise's objectives and constraints
- (f) Short-term costs
- (g) Long-term costs
- (h) Cost minimization
- (i) The enterprise's costs, technology and input prices

#### **1.1.4 Market structures: competition and monopoly**

- (a) The function of market in allocating scarce economic resources
  - (i) Goods and services
  - (ii) Financial markets
- (b) Types of market structures
- (c) The concept of perfect competition
- (d) Profit-maximization strategies of a competitive firm
- (e) Competitive industry in the long run
- (f) Why perfect competition is efficient
- (g) Monopolies and why they arise
- (h) The monopoly's profit-maximization price and output
  - (i) Price determination
- (j) Monopolies and efficiency issues
- (k) Rent-seeking and why it arises
- (l) Competition and monopoly at the domestic level

#### **1.1.5 Market structures: monopolistic competition and oligopoly**

- (a) The definition of monopolistic competition and oligopoly
- (b) Price and output in a monopolistically competitive industry
- (c) The efficiency of monopolistic competition
- (d) Price/profit strategies of enterprises in an oligopolistic industry
- (e) Price and output behavior of a cartel
- (f) Monopolistic competition and oligopoly at the domestic level
- (g) Information as an economic resource
- (h) Market failure and government action to overcome it

#### **1.1.6 National economic issues and measure of performance**

- (a) The costs and other aspects of unemployment
- (b) Inflation and its effects
- (c) The theory of imperfect competition in the market place
- (d) Gross domestic product (GDP), nominal GDP and real GDP
- (e) Growth and fluctuations in the nation's economy
- (f) The government's budget deficit
- (g) Measuring the national price level
- (h) GDP as a measure of economic performance and economic welfare

#### **1.1.7 Expenditure decisions**

- (a) Aggregate expenditure and its components
- (b) Consumption and saving decisions
- (c) The role of investments in the national economy
- (d) Net exports
- (e) Aggregate planned expenditure and real GDP
- (f) Equilibrium expenditure
- (g) The concept of the multiplier effect
- (h) Fiscal multipliers

**1.1.8 Money, banking and interest rates**

- (a) The nature of money
- (b) Financial intermediaries
- (c) Money creation
- (d) The national bank and its influence on the money supply
- (e) Demand for money
- (f) How interest rates are determined
- (g) The national bank's influence on aggregate national expenditures
- (h) Fiscal policies, interest rates and investment

**1.1.9 Unemployment and inflation**

- (a) Aggregate demand and what determines it
- (b) Aggregate supply and what determines it
- (c) Macroeconomic equilibrium
- (d) Wages and employment
- (e) Unemployment
- (f) Expectations
- (g) Expectations and macroeconomic equilibrium
- (h) Inflation

**1.1.10 The global environment**

- (a) Comparative advantages and gains from trade
- (b) The theory and practice of free trade and problems of protectionism
- (c) Foreign exchange controls and its effects and risks
- (d) Trade restrictions
- (e) Economic relations between developed and developing nations; problems of debt and development
- (f) Single market agreements, such as the European Union
- (g) Regional trade agreements, such as the North American Free Trade Agreement (NAFTA), the South American Common Market (MERCOSUR) and the Economic Community of West African States (ECOWAS)
- (h) International trade agreements such as the General Agreement on Trade in Services (GATS) and the World Trade Organization (WTO)
- (i) International institutions such as the World Bank and the International Monetary Fund (IMF) and their role in the world economy
- (j) Balance-of-payments accounts and implications of policies to achieve equilibrium
- (k) Financing international payments deficits
- (l) Exchange rate determination and alternative exchange rate regimes including the European Exchange Rate Mechanism (ERM)
- (m) Foreign exchange markets
- (n) Policies for national and international growth and development

**1.2. Module on quantitative methods and statistics for business**

*The objective of this module is to provide an understanding of how to calculate and use certain quantitative tools in practical business, industrial and governmental applications. After the methods of making the calculations are understood, computers are useful tools to*

perform the actual calculations. On completion of this module the individual should be able to:

- know how to formulate a problem in mathematical terms, solve the problem and be able to interpret the results.
- understand and apply statistical techniques, including methods of presentation of data, which are appropriate in a business environment.
- identify the accounting areas which can utilize the quantitative tools and techniques presented in this module to give them context and give examples
- understand the use and limitations of these tools and techniques.

### **1.2.1 Basic arithmetic operations with implications to accounting**

- (a) Arithmetic procedures, powers and roots, and logarithms
- (b) Percentages and ratios
- (c) Simple and compound interest concepts and nominal and effective interest rates
- (d) Discounted cash flows, net present values and internal rates of return measurements
- (e) The use of computers for arithmetic operations

### **1.2.2 Basic concepts of statistics - The measurement of uncertainty**

- (a) Probability concepts, addition and multiplication laws, and tree diagrams
- (b) Normal distribution concepts
- (c) Variance to expected values
- (d) Expectation concepts and their application to decision problems
- (e) Populations and samples
- (f) Frequency distributions
- (g) Measures of central location
- (h) Measure of dispersion

### **1.2.3 Statistical presentation as an aid to reporting information, such as histograms, pie charts, ogives, pictograms, frequency polygons and the Lorenz curve;**

### **1.2.4 The use of computer to generate statistical presentations of data and in generating and showing these presentations;**

### **1.2.5 Mathematical decision models to represent the relationship among elements relevant to a given situation and to determine the effects in external and internal conditions;**

### **1.2.6 Fundamentals of probability**

- (a) Basic probability concepts
- (b) Basic counting rules
- (c) Probability rules
- (d) Probability distributions

### **1.2.7 Probability distribution**

- (a) Binomial distribution

- (b) Continuous probability distributions
- (c) Normal probability distribution

### **1.2.8. Sampling and sampling distributions**

- (a) Sample designs
- (b) Sample statistics -
- (c) The sampling distribution of  $x$
- (d) The t-distribution

### **1.2.9 Statistical estimation**

- (a) Properties of estimators
- (b) Interval estimation
- (c) Sample size determination
- (d) Applications to auditing

### **1.2.10 Hypothesis testing**

- (a) Basic concepts of hypothesis testing
- (b) Hypothesis tests on the mean
- (c) Hypothesis tests on the proportion
- (d) Interval estimation and hypothesis testing

### **1.2.11 Regression, correlation, multiple regression, index numbers, and time series**

- (a) Simple linear regression
- (b) Correlation
- (c) Regression analysis
- (d) Multiple regression
- (e) Examination of regression assumptions
- (f) Index numbers and time series
- (g) Testing models

### **1.2.12 Statistical decision theory**

- (a) Probability rules and Bayles' rules
- (b) Probability/decision trees

### **1.2.13 Matrices and linear programming**

- (a) Matrices
- (b) Graphic linear inequalities
- (c) The linear programming model
- (d) Graphical sensitivity analysis
- (e) Use of the computer for linear, non-linear, and integer programming

### **1.3. Module on general business policies, basic organizational structure, and organizational behavior**

The objective of this module is to introduce the key concepts about different types of organizations and how they function in the practical context of the business environment and how they formulate their strategic planning. The module emphasizes the role of the corporation in corporate governance and in promoting ethical behavior. It also examines human behavior in organizations at the individual and group levels including the effect of organization structure on behavior. On completion of this module an individual should be able to:

- describe the nature and purpose of the main types of organizations and distinguish between different forms of organizational structures
- explain the nature and purpose of the strategies, values and policies which operate in organizations
- outline how the formal corporate structure functions
- explain how the socio-cultural and political environment affects the way in which organizations conduct business
- explain the important role of the corporation in corporate governance and the check and balance among the interests of the various constituencies .
- explain the impact of changes in technology on organizations
- appreciate the unique challenges faced by small enterprises
- understand how not-for-profit organizations function differently.
- identify the principles and concepts in the theories and practices of strategic management
- assess the impact of environmental forces on organizational strategies and plans
- understand and apply organizational behavior concepts
- understand interpersonal and team interaction with implications to human resources issues.
- understand organizational analysis and problem solving
- identify the accounting areas which can be impacted by the concepts presented in this module and tie them to accounting functions

#### **1.3.1 General business policies**

#### **1.3.2 Structure, function and objectives of different types of organizations**

- (a) The nature and functioning of commercial organizations, including sole proprietorships, partnerships and companies (corporations)
- (b) Non-commercial organizations, including public sector organizations, clubs and societies
- (c) The key personnel and their roles, responsibilities and relationships in organizations and the ways in which these might be integrated
- (d) The ways in which organizations may be structured
- (e) The functions within organizations
- (f) The strategy, aims, objectives, values, policies and conflicts which organizations may have, and the ways in which these are developing, in relation to:
  - (i) Alternative theories of the enterprise

- (ii) Innovation and change, quality and value for money
- (iii) Human resources issues, such as development and working conditions
- (iv) Clients and customers
- (g) The different forms which organizations may take in relation to the functions of :
  - (i) Administration
  - (ii) Finance
  - (iii) Personnel

### **1.3.3 The corporation and corporate governance**

- (a) The aims and objectives of a corporation and the goals of the different interest groups involved
- (b) The relationship between shareholders, bondholders, bankers and directors; the potential for conflicts of interests; the effect of the agency theory on concepts of governance
- (c) The concept of goal congruence and how it can be achieved
- (d) The role of non-executive directors, administrators, management buy-outs and buy-ins, executive share schemes, etc. in corporate operations
- (e) The ways and means of promoting ethical behavior within the organization and in relation to the outside world.
- (f) The role of the chief financial officer (CFO), the audit committee, internal auditors, and external auditors.
- (g) Discussion of corporate governance case studies in the local scene as well as relevant cases from the international scene.

### **1.3.4 Organizations and their structural and political environment**

- (a) Demographic structures and product and labor markets
- (b) Socio-economic groupings; the distribution of income and wealth
- (c) The influence of culture on organizational values, attitudes, behavior and performance
- (d) Social responsibility and organizations
- (e) Ethical behavior in the enterprise
- (f) The role of the state and its impact on organizations.
- (g) Political parties and pressure groups and their influence on government policy.

### **1.3.5 Strategic management and planning**

- (a) Distinguish between functional and strategic level.
- (b) Identify opportunities and threats from the environment as they impact organizations.
  - (i) The processes by which firms choose, maintain or redirect their strategic positions within ever-changing external environments.
  - (ii) Integrate business functions and identify the organization's position in relation to the outside environment.
- (c) Competitive advantage: its meaning in different national and international markets and industries
- (d) Forecasting the future for nations, industries, organizations and the workforce for changes, developments and opportunities
- (e) Strategic management and planning: its purpose; the methods used; the effect of the external environment on planning; and understanding and managing risk

- (f) Illustration of the role of accounting in setting and implementing management strategy.

**1.3.6 Organizations and technology: changes in technology and their implications for economic efficiency and growth, methods of production, types of products and organizational structure.**

**1.3.7 Special challenge faced by small enterprises**

**1.3.8 Not-for-profit organizations and governmental organizations**

- (a) The different goals of these types of organizations in comparison with for-profit organizations  
(b) Evaluation of programs  
(c) Measuring effectiveness and efficiency

**1.4. Module on management functions and practices and operations management**

The objective of this module is to provide candidates with an understanding of the different functions, duties and responsibilities of enterprise executives and managers. It develops candidates' awareness that strategic decisions are the result of a trade-off between various competing options considered by an organization's management. The module explores the decision-making process and the need to weigh the arguments, make choices and realize that, in most circumstances, there is not only one possible solution. The module introduces the accounting student to the decision making process in managing the production of goods and product planning, process planning, facility planning; and control of quantity, cost and quality with emphasis on inventory management, work methods, project management, productivity improvement. On completion of this module the individual should be able to:

- describe the nature of management and management styles
- explain the role of communications in organizations
- understand the importance of linking information systems development and management to business goals and needs
- projects evaluate ways in which change can be managed successfully and allocate resources in an optimum way.
- understand the manager's role and responsibilities in relation to the working environment
- assess the importance of human resources development to organizations and identify methods of managing people effectively
- identify the accounting areas which can be impacted by the concepts presented in this module and tie them to accounting functions

**1.4.1 The roles, functions and styles of management**

- (a) The nature, purpose, scope and interrelations of functions carried out by management in relation to resources, costs, operations and performance, namely
- (i) Setting objectives (long and short-term, strategic and operational, corporate and personal)

- (ii) Planning to meet objectives
- (iii) Implementing objectives
- (iv) Monitoring, evaluating performance and checking performance against objectives and plans
- (b) The role of management in relation to an organization's human resources and the relationship of management style to organizational structure
- (c) The nature of general management and the changing nature of managerial work
- (d) Organizing group activities into distinct work units and establishing relationships between them
- (e) Defining the authority, duties and responsibilities of people and work units
- (f) Concepts of organizing
- (g) Effective communication in organizations, both written and oral
- (h) Forms, styles and types of communication in organizations
- (i) Negotiation techniques and skills development
- (j) Promoting new ideas to others to gain their support
- k) Management integrity

#### **1.4.2 The role of the accountant in the management team in providing information and assisting in the analysis, interpretation and forecasting of business operations**

- (a) Seeking and clarifying information and views from others, including providing feedback to others
- (b) Isolating the key aspects of information and providing summaries for use by others
- (c) Presenting information clearly to others, both orally and in writing
- (d) Negotiating and agreeing with others
- (e) Promoting new ideas to others to gain their support
- (f) Giving and receiving constructive criticism to improve future performance
- (g) Advising others in one's areas of responsibility and expertise
- (h) Encouraging others to offer information, suggestions, etc
- (i) Ethical behavior among parties

#### **1.4.3 Managing operation and services**

- (a) Determining the work to be undertaken: time and resources needed and their costs; contingency planning
- (b) Planning resources allocation
  - (i) Setting work objectives
  - (ii) Designing and modifying methods of achieving work objectives
  - (iii) Optimizing the allocation of available resources
  - (iv) Formulating and evaluating work plans
  - (v) Reviews of previous plans and performance
  - (vi) The importance of time management.
  - (vii) Implications of resource allocation and work plan alternatives on costs, profitability
- (c) Monitoring and maintaining services
  - (i) Different concepts of quality
  - (ii) Methods for monitoring and evaluating the implementation of work plans

- (iii) Methods of assessing, analyzing and interpreting information on service
- (iv) Delivery and other non-financial targets, resource utilization and costs –
- (v) Inventory control.

#### **1.4.4 Human resources management**

- (a) Cultural differences and compensation and performance evaluation
- (b) The purpose and forms of personnel specifications in the recruitment of personnel
- (c) Methods of identifying competencies and other attributes required
- (d) Specifying personnel requirements
- (e) Evaluating and determining the benefits and costs of new or additional personnel
- (f) Identifying and determining suitable methods of recruitment
- (g) Selection methods and their use
- (h) Methods of motivating and supporting personnel
- (i) Staff appraisals and the assessment of competence
- (j) Warning and dismissing personnel: legal and organizational policies and procedures; the role of internal and external specialists in the process
- (k) The role of employee groups in promoting the welfare of personnel
- (l) National legislation which affects recruitment, selection, employment and dismissal of personnel
- (m) The management of organizational and personal changes
- (n) Concepts and principles of human resources development
  - (i) The role which individual and team development can play in growth and development
  - (ii) The different concepts and models of competence
  - (iii) Methods of encouraging and supporting individuals and teams to grow and develop (including issues such as stress management and time management).
  - (iv) The effect of internal and external factors on personnel development

#### **1.4.5 Management of the working environment**

- (a) Organizational structure, forms, and culture.
- (b) Motivation, employment contract, diversity, negotiation, communication, leadership and teamwork.
- (c) Interrelationship of organizational elements in maintaining a functioning organization.
- (d) Monitoring, interpreting and applying best practices
- (e) National legislation which affects the working environment
- (f) The role and purpose of health, safety and security requirements, procedures and guidelines
- (g) Roles and responsibilities of persons for managing and improving the working environment

#### **1.5. Module on marketing**

The objective of this module is to introduce students to the nature of marketing, the fundamentals of marketing strategy, and marketing environment. The module explores global competition, ethical and moral marketing behaviors, the business environment under which marketing operates, and the role of technology in a changing world. It investigates the

marketing of goods and services by commercial organizations as well as the marketing of ideas by not-for-profit firms. Upon completion of this module individuals should be able to:

- evaluate the strategic role of marketing
- explain the major distribution function of marketing
- understand buyer behavior, market segmentation, targeting, positioning and the role of the Internet in the practice of marketing
- understand integrated marketing communications through advertising, sales promotion, publicity, and public relations
- understand the role of pricing and pricing strategies employed in the successful marketing of goods and services.
- identify the accounting areas which are impacted by the concepts presented in this module and give examples.

### **1.5.1 Nature of marketing**

- (a) The purpose and functions of marketing,
- (b) The fundamentals of marketing strategy, and the different roles which marketing plays in the economy,
- (c) The business environment under which marketing operates,
- (d) The ethical and moral marketing behaviors.
- (e) Analyzing market needs and identifying marketing opportunities and how to improve the services offered
- (f) Obtaining competitive advantages: market segmentation, targeting and positioning strategies
- (g) The marketing of goods, services and ideas by businesses as well as by not-for-profit firms.
- (h) Consumer Behavior: Decision-Making Processes and Socio-cultural Forces

### **1.5.2 The nature of distribution**

- (a) Retailing and Wholesaling
- (b) Physical Distribution Management

### **1.5.3 Promotion and advertising**

- (a) Advertising
- (b) Sales Promotion
- (c) Public Relations

### **1.5.4 Pricing**

- (a) Introduction to Pricing Concepts
- (b) Pricing Strategies and Concepts

### **1.5.5 Special topics in marketing**

- (a) Strategies for New Products and the Product Life Cycle (PLC)
- (b) The Marketing of High Quality Services
- (c) Integrated Marketing Communications

### **1.5.6 The impact of the global economy on marketing**

- (a) Relationships between Transnational Corporations and developing countries.
- (b) The role of transnational corporations in economic development.
- (c) Relationships with host countries.
- (d) The Microenvironment in an Era of Global Competition
- (e) Global Information Systems and Marketing Research
- (f) The emerging role of the Internet and the role of technology in marketing
- (g) Transfer pricing revisited.
- (h) Unfair transfer pricing strategies and the incentives for these.
- (i) Effects of unfair transfer pricing strategies on the economies of developing countries.
- (j) Detecting unfair transfer pricing strategies

### **1.6. Module on international business**

The objective of this module is to explore the role of global financing, investing and operating activities and their impact on business and trade. The module exposes students to the challenges and opportunities in doing business in a global environment. Upon completion of this module individuals should be able to:

- understand the global environment in which business operates
- outline the major financial decisions faced by managements in conducting international business
- comprehend the role of the multinational corporation, the challenges it faces and the power it commands
- assess the role of the global environment on small business and the challenges it faces and the opportunities it presents
- appreciate the impact of globalization on human resources

#### **1.6.1 Organizations and their international environments**

- (a) The importance of international trade
- (b) The globalization of markets
- (c) The development of multinational and transnational corporations

#### **1.6.2 International business: competing in the global economy**

- (a) International factors affecting business developments:
- (b) The role of transnational corporations in the world economy with particular emphasis on the role of financial markets in shaping management decisions of international firms:
  - (i) The ever emerging global economy,
  - (ii) National differences in economy and culture,
  - (iii) Cross-border trade and investment,
  - (iv) The global trading and monetary system,
  - (v) Foreign direct investment,
  - (vi) Regional economic integration,
  - (vii) The foreign exchange market.

- (c) International financial management decisions:
- (a) Alternative methods of financing imports and exports
  - (b) The workings of international money and capital markets and the opportunities that they offer to companies as a source of finance and as a repository for the investment of funds
  - (c) The management of financial resources within a group of companies, including:
    - payment between companies,
    - cash management,
    - transfer pricing,
    - judging the performance of companies within a group,
    - the financial control of a group of companies
  - (d) The appraisal of international capital investments, applying the appropriate techniques, and the consideration of the major issues in the decision-making process, including:
    - strategic objectives,
    - the principle of home country vs. host country returns,
    - the form of foreign investments including use of branches vs. subsidiaries,
    - the different methods of financing foreign investments,
    - the effect of taxation on foreign investment decisions,
    - repatriation of sales amounts, earnings and charges to foreign operating companies,
    - political risk analysis.

### **1.6.3 The international firm**

- (a) Dimensions of culture
- (b) Organizational structure
- (c) Management and the structure of multinational firms

### **1.6.4 International HRM issues.**

- (a) Globalization and human resource strategy
- (b) Dealing with intercultural differences
- (c) Selecting employees for foreign assignments
- (d) Training and developing expatriate employees
- (e) Evaluation and compensation of employees in international assignments

## **2. Information Technology**

### **2.1 Module on information technology (IT)**

The objective of this module is to ensure that candidates appreciate the contribution of information systems to meet the goals and needs of business and to understand procedures for the development, introduction and use of computer-based systems. The subject matter should be taught from the perspective of their usefulness and application to business situations; the technology should not be seen as an end in itself. The module starts with basic survey materials pertinent to equip the student to have a consumer's understanding of IT. The study of information technology should be integrated as far as possible in the study of subjects in the other modules, and not as a separate stand-alone, self-contained technical skills course. The subject matter described in this module represents the scope of knowledge, which should be learned. On completion of this module the individual should be able to:

- describe different types of information system, with particular reference to financial systems
- understand what IT is about, i.e., that is, what the IT people do
- understand what the points of interaction are between the accountant and the IT functional areas i.e., where the IT specialists need the help of the accountants and conversely where they can help the accountants
- understand working with large-scale systems.
- understand their role in the decision-making process and their relationship to the organization
- understand the internal controls in data processing systems
- describe and apply the main tools and techniques of systems analysis, design and development
- evaluate the performance of information systems
- describe systems for the security of data and applications and cost implications, not just descriptions
- describe the tools that are available to assist in efficient project management.
- discuss the procedures to enable systems maintenance to be carried out in an accurate and timely manner
- understand upgrade and replacement cycles
- understand the problems of managing existing resources such as desktop inventory and how to handle maintenance cycles for all equipment in the organization
- understand the importance of electronic commerce in the current business environment and understand how it works, what it costs, and what changes it causes in the firm
- understand the implications for changing the equipment configuration, software configuration, etc.
- Expose students to Knowledge Management – particularly knowledge management for accounting knowledge

#### **2.1.1 IT concepts for business systems - Survey of IT pertaining to accounting functions**

- (a) General system concepts
  - (i) Systems theory, system objectives and types of systems
  - (ii) System architectures

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- (iii) Control and feedback in systems
  - (iv) The nature, types and attributes of information
  - (v) The role of information within business
- (b) Management's use of information – General overview
- (i) Decision theory
  - (ii) Human information processing
  - (iii) Transaction processing in typical business applications
  - (iv) The communication of information
  - (v) Financial analysis, decision support, executive information systems, and business intelligence
  - (vi) General ledger, budgeting and information systems.
- (c) IT infrastructure and rules as they pertain to accounting functions
- (i) Hardware
    - Capabilities
      - PC
      - Mid-range & mainframes
      - Wireless
    - Cost/Replacement cycles
  - (ii) Software
    - Applications/operating systems capabilities
    - Application software strategy
    - Integrated systems
    - Databases
    - Nature of the IT industry & IS contracts
    - Software (creation & maintenance.)
    - Cost/replacement cycles
  - (iii) Telecom
    - Cost
    - Capabilities
    - Bandwidth
    - Wireless
    - Providers
    - Regulatory environment
  - (iv) Security
  - (v) Privacy
- (d) Accountants functions with respect to IT
- (i) Specify types and characteristics of
    - End user hardware
    - Application software
    - Telecommunications infrastructure

(ii) Interact with IS

- Group level
- Individual level
- Software specification
- Software acceptance testing
- Software maintenance

(iii) Interaction of accountants with IT technical staff

(iv) Accountant's role on computer/IT/IS committees

(v) In strategic decisions about IT such as:

- Resource allocations
  - Hardware to be obtained
  - Applications to be available
  - Infrastructure to be put in place (telecom, intranets, extranets)
  - Make vs. buy decisions on hardware, software
  - Outsourcing vs. In-sourcing
  - Automating business functions
  - Business Process Reengineering
  - Adoption of new technologies
  - Strategic Use of IT
- Outsourcing
- Strategic use of IT

(e) Data organization and access methods

- (i) Data structures and file organizations
- (ii) Access methods and the maintenance
- (iii) Types of data files
- (iv) Data base management systems
- (v) Document management

(f) Networks and electronic data transfer

- (i) Network components, configurations, and designs
- (ii) Internet, intranet and extranet applications
- (iii) Data communication and transmission devices/software
- (iv) Message and document communication
- (v) Operation management and control

(g) Transaction processing in typical business applications

- (i) General application processing phases
- (ii) Processing models
- (iii) How different classifications of transactions are processed (e.g. purchases, sales, etc)
- (iv) Production planning and scheduling, including ERP, computer-aided design CAD and CAM

### 2.1.2 Internal Control in computer-based business systems

- (a) Control objectives
  - (i) Risks and exposure in computer-based information systems
  - (ii) The effect of the computer on processing controls
  - (iii) The effect of IT on organizations and control
  - (iv) Responsibility for controls
  - (v) Effectiveness and efficiency of operations
  - (vi) Reliability of financial reporting
  - (vii) Compliance with applicable laws and regulations
  - (viii) Cost effectiveness of control procedures
- (b) Control framework
- (c) The control environment
  - (i) Management philosophies and operating styles, organization plans and structures, communication methods and control methods and their effects on system development
  - (ii) Control over system selection, acquisition and development
  - (iii) Control over system implementation
  - (iv) Control over system and program changes
- (d) Risk assessment
  - (i) Risk exposures
  - (ii) Probability and consequences of loss
  - (iii) Preventive, detective and corrective strategies
- (e) Control activities
  - (i) The function of accounting systems
  - (ii) Administrative and accounting control procedures
  - (iii) Control design
  - (iv) Continuity of processing, disaster recovery planning and control
  - (v) Information system processing and operations from a control point of view
- (f) Monitoring compliance with control – the role of management users, internal auditors and external auditors

### 2.1.3 The management of IT adoption, implementation and use

- (a) Strategic consideration in IT development
  - (i) Planning of information systems based on business success factors and criteria
  - (ii) Components of long-range plans
  - (iii) Integration with business objectives and success factors
  - (iv) Participation in strategic planning
- (b) Administrative Issues
  - (i) Job functions, organization and reporting relationships of the IT department
  - (ii) Recruiting and developing information systems human resources (IT service in-house vs. outsourced packaged software).

- (c) Financial control over IT –budgeting and cost control
  - Operational issues
    - (i) Developing operational priorities
    - (ii) Management of computer operations
    - (iii) Management of inter-organizational computing
- (f) Management of system acquisition, development, and implementation
  - (i) Development acquisition alternatives
  - (ii) Standards and controls applicable to IT development projects
- (g) The management of system maintenance and change - standards and control
- (h) The management of end-user computing – the role of information centers
- (i) Charge-back schemes

#### **2.1.4 Managing the Security of Information**

- (a) Control over data integrity, privacy, and security
- (b) Importance of information security
- (c) Principles of information security
- (d) Best approaches to implementing information security
- (e) Trade-off between cost of security and amount of security

#### **2.1.5 Electronic Commerce**

- (a) The nature of electronic commerce
- (b) Intra-company applications
- (c) The extranet and its applications for managing supply chains with suppliers, vendors, and contractors
- (d) The Internet and the worldwide web
- (e) The marketing of products and services
- (f) External customers transactions, payments and transfers
- (g) On-line banking (*as it affects the firm's treasury*).
- (h) Financial electronic data interchange (FDI)
- (i) Security matters related to electronic commerce

#### **2.1.6 Accounting, finance and related knowledge**

This accounting, finance and related knowledge section of the curriculum is made up of 10 required core (basic) modules and seven elective (advanced) modules. Each institution adopting the MC should cover the core modules. The institution's curriculum planning process should set additional requirements (minimum of three modules) from among the seven elective (advanced) modules. The selection of electives should be consistent with 1) the mission and goals of the institution, 2) the environment in which it operates, and 3) the needs of students to specialize in one of the accounting specializations.

### 3. Core (Basic) Accounting, Auditing, Taxation, And Accounting-Related Knowledge

#### 3.1 Module on basic accounting

The objective of this module is to equip candidates with the basic understanding of the principles and concepts of accounting as well as their applicability and relevance in the national context and with the ability to apply these principles and concepts in the preparation of financial and related information to meet internal and external obligations. On completion of this module individuals should be able to:

- outline the role and principles of financial accounting and reporting
- identify, measure, and communicate economic and financial events that are subject to accounting treatment.
- prepare financial statements for both incorporated and non-incorporated enterprises
- discuss the accounting treatment of long-life assets, short-life (current) assets, liabilities, goodwill, research and development costs, contingencies, and events after the date of the latest balance sheet (statement of financial position)
- understand and apply relevant International Accounting Standards applicable to the topics in the module
- communicate the results of the financial accounting process through properly prepared financial statements.
- interpret and use financial information for business decision-making
- appreciate the importance of professional judgment and ethics in making accounting and financial reporting decisions.

##### 3.1.1 Introduction to accounting

- (a) Define and explain accounting identifying its functions, scope, and objectives.
- (b) Differentiate among the different branches of accounting (financial, managerial, etc.)
- (c) The classical notion of stewardship
- (d) Double entry bookkeeping
- (e) The Florentine vs. the Venetian approach to reporting
- (f) Savory and the Napoleonic Commercial Code
- (g) The industrial revolution and the share-issuing company
- (h) The arrival of income taxation and the conflict with financial accounting.
- (i) Schmalenbach and the charts of accounts
- (j) The rise of the Group of Companies and the need for consolidated account
- (k) Accounting variations among countries
  - (i) Why practices differ from one country to another even though the same set of basic principles is followed
  - (ii) The linkage of tax laws and accounting principles requirements for enterprises in certain countries
  - (iii) Differences in the degree of development of the capital markets in countries and their effect on the development and use of generally accepted international principles of accounting
- (l) Internationalization of markets and reporting

### **3.1.2 The nature of the accounting profession**

- (a) Italian initiatives in the sixteenth century
- (b) Origins of the modern profession in the early nineteenth century
- (c) Creation of the Chartered Institutes in Scotland and England
- (d) The development of professional bodies in the English-speaking world
- (e) Developments in Germany and France in the twentieth century
- (f) The international dimension and the “big four” international accountancy firms

### **3.1.3 Basic professional values and ethics**

- (a) Reputation
- (b) Integrity and due care
- (c) Competence
- (d) Objectivity
- (e) Client relations and confidentiality
- (f) Reporting breaches of conduct
- (g) Unlawful activities
- (h) Fees and remuneration
- (i) Publicity and advertising
- (j) Disciplinary procedures

### **3.1.4 Standard-setting and regulation in accounting practice**

- (a) Early sources of regulation
  - (i) Public sector regulation of accounting practice
  - (ii) National securities commissions and their role in accounting regulations
  - (iii) Private sector standard-setting for accounting practice
- (b) Harmonization of accounting practice Internationally
  - (i) The International Accounting Standards Board (IASB) and its IFRS
  - (ii) The United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR)

### **3.1.5 National concepts and principles relating to the preparation and presentation of financial Statements**

- (a) The nature, principles and scope of accounting
- (b) The nature, principles and objectives of financial and related records of an organization
- (c) The users of financial and related information and their varying needs
- (d) The assumptions underlying general-purpose financial statements
- (e) The qualitative characteristics of financial statements
- (f) The elements of financial statements
- (g) Criteria for the recognition of the elements of financial statements
- (h) Measurement of the elements of financial statements
- (i) The concept of capital and capital maintenance

- (j) The nature, role and significance of accounting theories and principles
- (k) Principles of conceptual frameworks of accounting
- (l) Generally accepted accounting standards
- (m) The concept and role of the true and fair presentation of financial statements

### **3.1.6 Identifying, measuring and communicating economic and financial transactions applying IAS and IFRS**

- (a) Double-entry bookkeeping and accounting systems.
- (b) Introduction to manual and electronic bookkeeping systems
- (c) The classification of expenditures between capital and revenue transactions
- (d) The accounting treatment of disclosures of accounting policies
- (e) The accounting treatment of current assets such as cash and deposits, accounts receivable and prepayments, bad and doubtful accounts, and inventories or stocks
- (f) The accounting treatment of long life (term) assets such as tangible (fixed) assets and intangible assets (including goodwill and research and development costs), and the depreciation and amortization of such long life assets
- (g) Valuation and reporting of investments in debt and equity securities
- (h) The accounting treatment of current and long-term liabilities and provisions
- (i) The nature, purpose and accounting treatment of shareholders' equity and reserves
- (j) Accounting for leases
- (k) The presentation of financial statements
- (l) Post-balance-sheet events and contingencies
- (m) Confirming and correcting mechanisms in book-keeping and accounting systems, such as control accounts, bank reconciliation and suspense accounts, and the correction of recording errors

### **3.1.7 The preparation and presentation of financial statements for business enterprises (under conditions of stable prices)**

- (a) Income statements
- (b) Balance sheets
- (c) Cash flow statements
- (d) Value-added statements
- (e) Statement on Changes in Equity

### **3.1.8 Basic interpretation and use of financial statements**

- (a) Contrasting the concepts of funds flow and cash flow
- (b) The computation, interpretation, and limitations of significant accounting ratios for financial statement analysis purposes
- (c) Appraising and communicating the financial position and prospects of a business based on given and prepared statements and ratios
- (d) Appraising the validity of available information for user purposes

## **3.2 Module on financial accounting**

The objective of this module is to ensure that candidates have developed a thorough knowledge and understanding of accounting principles and concepts and can apply this

grounding to the situations that they will typically encounter in practical work situations. On completion of this module individuals should be able to:

- appraise theoretical and regulatory national accounting frameworks and international accounting standards
- prepare income statement and statement of cash flows, income measurement, balance sheet, financial disclosures, time value of money concepts, current assets (cash and receivables, inventory), operational assets, investments, current liabilities, contingencies, bonds, notes, leases, accounting for income taxes, pensions, employee benefit plans, shareholders' equity, accounting changes, earnings per share.
- analyze and interpret financial and related information and produce reports to meet the needs of internal and external users
- develop a professional in-depth understanding of underlying accounting concepts

### **3.2.1 The theoretical accounting framework – applying IAS and IFRS**

- (a) The objectives of financial statements
- (b) Qualitative characteristics of financial information.
- (c) Users of financial statements and their information requirements
- (d) Accounting conventions
- (e) The interpretation and application of theories of accounting in relation to
  - (i) The recognition and measurement of income
  - (ii) Capital maintenance
  - (iii) The valuation of assets and liabilities
- (f) The accounting recognition of assets, liabilities and shareholders' equity transactions
- (g) Principles of accounting for revenues and costs

### **3.2.2 The preparation of the different types of financial statements and other special accounting issues – applying IAS and IFRS**

- (a) The conversion of an unincorporated enterprise into a corporation
- (b) The concepts of pre-incorporation profits, distributable profits and the purchase of an enterprise's own shares
- (c) Accounting for joint ventures and associated enterprises
- (d) Interim (i.e. other than year-end) financial reporting by enterprises
- (e) Fair value accounting
- (f) Accounting for financial instruments, such as derivatives and other hedging instruments
- (g) Accounting for environmental cost and liabilities
- (h) Accounting for governmental assistance
- (i) The role and function of the special (national/regional) standard setting organizations

### **3.2.3 The preparation of financial statements for various types of organizational entities**

- (a) The preparation of accounts from incomplete information and records

- (b) Partnership accounting, including accounting for the admission of partners, changes in capital and profit and loss-sharing ratios, and the retirement, dissolution and goodwill adjustments for partnership interests
- (c) Accounting for proprietorships and other unincorporated enterprises
- (d) Accounting for incorporated enterprises, including the preparation of financial and other statements for internal and external purposes
- (e) Fundamentals of accounting for not-for-profit organizations
- (f) Introduction to accounting for foreign subsidiaries and branches, and accounting for foreign currencies

### **3.2.4 Advanced concepts for analyzing and appraising financial and related information**

- (a) Interpreting and analyzing financial statements for indications of business performance
- (b) Use of computers for financial analysis
- (c) Assessing information weaknesses in financial statements
- (d) Business valuation

### **3.2.5 The communication of information to users: the preparation of reports to meet the needs of internal and external users, supported by appropriate accounts and financial statements, which include necessary information and explanations**

- (a) The results of operations and the state of affairs
- (b) Projected results
- (c) Accounting policies and practices used
- (d) The main assumption on which the reports are based
- (e) Significant departures from IAS and IFRS and national standards, and assumptions and policies
- (f) Graphic presentation of financial data for users, including the use of computer-generated graphics

## **3.3 Module on advanced financial accounting**

The objective of this module is to ensure that candidates can exercise judgment and techniques in accounting encountered by professional accountants, and can evaluate and react to current developments or new accounting practices. Institutions can add to this module any legal and/or unique financial reporting requirements applicable to this environment. On completion of this module the individual should be able to:

- interpret, apply and appraise critically emerging professional accounting and reporting issues and exposure drafts.
- understand, apply, and critically evaluate the theoretical and practical issues involved in the identification, measurement and communication of tangible and intangible non-monetary assets, monetary assets and liabilities.
- analyze and interpret financial statements and other related information.
- prepare reports of groups of companies, consolidated financial statements
- develop a critical appreciation of the functions of financial accounting and reporting and further strengthen practical and analytical accounting skills

- understand the theory underlying financial accounting practices and apply this theory to the study of accounting regulations.
- critically evaluate and apply relevant accounting standards through a study of conventional and alternative accounting practices.

### **3.3.1 The Professional activities of accountants – applying IAS and IFRS**

- (a) Critically appraising, evaluating proposed changes and promoting changes in
  - (i) Accounting theories and principles,
  - (ii) Concepts
  - (iii) IFRSs, IASs, Exposure Drafts of IASs and other IASB publications
- (b) Monitoring and evaluating
  - (i) International issues and case law
  - (ii) Ethical issues

### **3.3.2 Group (consolidated) accounts**

- (a) The concept of group accounts
- (b) General principles for the preparation of group accounts
- (c) Inter-company eliminations in the preparation of group accounts
- (d) Translation methods for preparing group accounts of entities whose individual accounts are expressed in more than one currency
- (e) Other methods of accounting for groups of enterprises
- (f) The equity method of accounting,
- (g) The proportional consolidation method
- (h) Financial instruments, such as derivatives and other hedging instruments
- (i) The use of computers for preparing combining and consolidating groups of accounts

### **3.3.3 Assessing informational weaknesses and limitations of financial statements and analyses**

### **3.3.4 Special topics dealing with local legal financial reporting requirements or issues unique to this environment**

## **3.4 Module on management accounting – basic concepts**

The objective of this module is to generate accounting information capable of facilitating managerial decisions at all levels in their efforts to efficiently and effectively allocate the organization's scarce economic, human, and financial resources. This objective is to be accomplished through a thorough understanding of how the information generated is being used. Therefore, emphasis on the content and delivery of management and cost accounting methods and techniques are taught within the context of the decision-making processes. On completion of this module the individual should be able to:

- discuss the role of cost and management accounting and quantitative analysis within the organization.
- analyze and solve different types of managerial accounting decision-making problems by applying various management accounting techniques and methods
- use various classifications to analyze costs within the organization.

- describe and apply the principles relating to the costing of the different resource inputs into a business.
- demonstrate output costing methods appropriate to a variety of different businesses.
- illustrate and evaluate absorption, marginal costing, activity-based costing methods and other management cost accounting methods and techniques.
- describe, illustrate and comment on the planning and control uses of standard costing, budgeting and variance analysis
- describe, illustrate, and comment on the planning and control uses of standard costing, budgeting, and variance analysis

### **3.4.1 Background information**

- (a) Importance of knowledge of the business processes and their technological implications
- (b) The role of quantitative techniques in problem-solving situations
- (c) The value of qualitative and quantitative information in decision-making
- (d) The interpretation of operating results and evaluation of the impact of optimum decisions
- (e) The benefit of computer software (e.g. spreadsheets and statistics packages) in handling numerical information
- (f) The importance of effective communications to users of information

### **3.4.2 The cost and management accounting framework**

- (a) Cost and management accounting in comparison with financial accounting: their purposes, the role of cost accounting as part of a management information system, and the need for both financial as well as non-financial information
- (b) Cost classification concepts and terminology, such as:
  - (i) Direct and indirect costs,
  - (ii) Fixed and variable costs,
  - (iii) Period and product costs,
  - (iv) Controllable and uncontrollable costs,
  - (v) Avoidable and unavoidable costs,
  - (vi) “Sunk” costs,
  - (vii) Budgeted, standard and actual costs and their comparisons and analyses
- (c) The use of linear, curvilinear and step functions and how their calculations are used to analyze cost behavior
- (d) The concepts of cost units, cost centers and profit centers
- (e) describe, illustrate and comment on the planning and control uses of standard costing, budgeting and variance analysis
- (f) The difference between absorption and marginal costing systems

### **3.4.3 Cost determination: the costing of resource inputs**

- (a) Materials
  - (i) Accounting for stock (inventory) movements
  - (ii) Determination of optimum purchase quantities
  - (iii) Material pricing issues
  - (iv) Identification of accounting for stock losses

- (b) Labor
  - (i) The difference between direct and indirect labor
  - (ii) Types of labor remuneration methods
  - (iii) Labor efficiency calculations and interpretations
  - (iv) Recording labor costs
  - (v) Calculation and interpretation of labor turnover rates
- (c) Overheads
  - (i) Overhead cost analyses
  - (ii) The apportionment and absorption of overhead costs, including reciprocal service situations
  - (iii) Accounting for the over- and under-absorption of costs

#### **3.4.4 Costing methods: the costing of resource outputs**

- (a) Job order, batch and contract costing methods
  - (i) Characteristics of each method
  - (ii) Accounting for direct and indirect costs, including the treatment of waste, scrap and rectification costs,
  - (iii) Calculation of the profit on partially completed contracts
- (b) The process costing method:
  - (i) Characteristics of the process costing method,
  - (ii) Identification and use of appropriate cost units,
  - (iii) Valuation of process transfers and work-in-process using equivalent units of production and based on FIFO and average costing methods,
  - (iv) Accounting for normal and abnormal losses and gains, joint and by-products
- (c) Operation or service costing
  - (i) Scope of operation or service costing,
  - (ii) Identification of appropriate cost units,
  - (iii) Considerations relating to the collection, classification and ascertainment of costs
- (d) Standard costing

#### **3.4.5 The pricing of goods and services**

- (a) Target and minimum pricing.
- (b) Price /demand relationships,
- (c) The pricing of special orders and short-life products,
- (d) Transfer pricing between divisions in a group,
- (e) Pricing in service industries,
- (f) Pricing internal services

**3.4.6 Costing systems: marginal contrasted with absorption costing**

- (a) The concept of profit contribution
- (b) The difference between marginal and absorption costing
- (c) Marginal cost accounting: process cost accounting transactions in a marginal costing system
- (d) Cost-volume-profit (CVP) analysis: understanding the concepts of break-even and margin of safety

**3.4.7 Cost and management accounting methods**

- (a) Cost control (as distinguished from cost determination); control over waste, scrap, spoilage and defective items
- (b) Determining and allocating or apportioning the costs of activities and outputs through the use of appropriate concepts, methods and techniques for:
  - (i) Absorption costing,
  - (ii) Marginal costing,
  - (iii) Opportunity costing
- (c) Activity-based costing; use of cost drivers and activities
- (d) Alternative stock (inventory) management systems and models including total quality management (TQM), “just in time” (JIT), economic order quantities (EOQ), etc.
- (e) Consideration and application of information required in relation to
  - (i) The costing of products and services
  - (ii) Preparing plans
  - (iii) Monitoring and controlling performance and
  - (iv) Decision-making needs
- (f) Relevance, costs, and the decision process
- (g) Cost reduction: techniques such as work-study, time and motion studies and value analysis

**3.4.8 Budget as a tool for decision-making**

- (a) Master budgets
- (b) Flexible budgets and variances analysis

**3.4.9 Information for budgeting, planning and control purposes**

- (a) Objectives and concepts of budgetary systems
  - (i) Budgeting as a multi-purpose activity,
  - (ii) Budgeting and behavioral influences,
  - (iii) Quantitative aids in budgeting: learning curve theory and application; limiting factors and linear programming,
  - (iv) Activity-based budgeting,
  - (v) Control theory and budgeting,
  - (vi) Uncertainty and budgeting,

- (vii) Identification of relevance, strengths and weaknesses of budgeting and budgetary control
- (b) Types of budgetary systems: fixed and flexible budgets, zero-based budgets, and incremental, periodic and continuous budgeting
- (c) Developing and implementing budgeting systems: functional and subsidiary budgets and master budgets, including cash budgeting
- (d) Monitoring and controlling performance; the calculation of variances; the determination of the causes of variances
- (e) Short-term vs. long-term budgets
- (f) Quantitative aids in budgeting: least squares regression; scatter diagram with correlation; forecasting with regression; time series and seasonality concepts for the analysis of time-related data

#### **3.4.10 Standard costing**

- (a) The uses and limitations of standard costing methods
- (b) The determination of standards
- (c) Identification and calculation of variances: sales variances (including quantity and mix); cost variances (including mix and yield); absorption and marginal approaches
- (d) Identification of significant variances and their interrelationship
- (e) The uses of planning and operational variances
- (f) Trends, materiality and controllability of variances
- (g) Uncertainty and variance analysis
- (h) Identification of relevance, strengths and weaknesses of standard costing and variance analysis for performance and control

#### **3.5 Module on taxation**

The objective of this module is to differentiate between tax accounting and financial accounting and to introduce the mechanics of major taxes, in particular those of corporate tax, personal taxes and value added tax, if applicable particularly those that are likely to be encountered during the initial phase of a candidate's tax experience in professional practice and to equip candidates to solve unstructured problems in the future. On completion of this module the individual should be able to:

- distinguish between financial accounting and tax accounting
- discuss the operation of the national taxation system
- compute the income tax liabilities arising from individual and unincorporated businesses
- compute tax liabilities for companies
- display an awareness of the impact of all major taxes on the transactions of individuals, partnerships and corporations
- apply that knowledge to practical situations involving computation, explanation, discussion and advice
- appreciate the importance of taxation in personal and corporate financial planning and decision-making
- demonstrate an understanding of the national tax regulations associated with the provision of suitable investment advice to individuals

- identify opportunities to minimize potential tax liabilities by making full use of available options, relief and other forms of available allowances

### **3.5.1 Overview of the national tax system**

- (a) The philosophy and genesis of taxation and relationship between government stewardship of national resources and taxation.
- (b) Structure and procedures of the national, regional and local taxation authority
- (c) Duties and powers of taxation authorities and the nation's legal system
- (d) Assessments, due dates, interest on overdue amounts, and refunds of amounts paid
- (e) Sources of tax information: statutes, case laws, regulations and other sources
- (f) Resolution of tax disputes

### **3.5.2 Taxation of incorporated businesses**

- (a) The principles and scope of corporation taxation laws
- (b) Calculating tax liabilities
- (c) Special regulations applicable to groups of companies
- (d) Minimizing and deferring tax liabilities
- (e) Purchases and sales of a company's own shares
- (f) Tax effects of the acquisition and sales of companies owned

### **3.5.3 Capital gains tax**

### **3.5.4 Local direct taxes, including real estate and other property taxes**

### **3.5.5 Tax planning and the application of appropriate tax planning measures**

### **3.5.6 The use of computers for tax planning and for the preparation of tax returns**

### **3.5.7 Ethical considerations – tax avoidance and the minimization of tax liabilities vs. tax evasion**

### **3.5.8 Other taxes such as excise taxes and road taxes –C/E**

### **3.5.9 National and culturally-determined insurance schemes – C/E**

### **3.5.10 Social security schemes –C/E**

### **3.5.11 Value-added tax schemes –C/E**

### **3.5.12 Other culturally-determined taxes –C/E**

## **3.6 Module on accounting information systems (AIS)**

The objective of this module is to adopt an up-to-date perspective of accounting information systems incorporating a version of an efficient real time accounting systems. On completion of this module the individual should be able to:

- develop an understanding of organisations - their activities, processes, and the information needs of organisation stakeholders.
- develop awareness of the processes and disciplines associated with the design and control of accounting information systems.
- develop awareness and an understanding of information risk assessment and control procedures.
- develop awareness of the resources available to build a real time Accounting Information Systems.
- develop the ability to collate and present information in a timely and effective manner.
- demonstrate an understanding of various accounting and business processes in an information systems context.
- discuss and apply the principles of business system design.

### **3.6.1 Introduction to accounting information systems**

- (a) Review of manual accounting systems
- (b) Traditional AIS
- (c) Data concepts
- (d) Business system design

### **3.6.2 Development standards and practices for accounting information systems**

- (a) The role of information in organization design and behaviour
  - (i) Databases and database management systems
  - (ii) System development life cycle
  - (iii) Risks: economics, technical, operational and behavioral
  - (iv) Controls
- (b) System analysis and design techniques
  - (i) Information requirements elicitation
  - (ii) Documentation of analysis and requirements
  - (iii) System design
- (c) System acquisition, development life cycle phases, tasks and practices, and maintaining control over system development processes
  - (i) Investigation and feasibility studies
  - (ii) Requirements analysis and initial design
  - (iii) Detailed design specification and documentation
  - (iv) Hardware evaluation and acquisition and development
  - (v) Software evaluation and acquisition and development
  - (vi) Selection of an internet service provider
  - (vii) Hardware contracts and software licenses
  - (viii) System installation and implementation
  - (ix) Testing (system verification)
  - (x) User procedures and training
  - (xi) Design of user and operator control procedures
  - (xii) Testing (system validation)

- (xiii) System conversion and start-up
- (xiv) Post-implementation review
- (xv) Maintenance of hardware and software
- (xvi) System documentation and operation manuals

### **3.6.3 Accounting system design issues**

- (a) System acquisition
- (b) Basic flowcharting techniques/systems
- (c) File processing:
- (d) Master files
- (e) Transaction files
- (f) Periodic reporting.
- (g) Problems with the traditional approach

### **3.6.4 Internal and systems controls**

- (a) Frameworks for internal control
- (b) Specific internal control techniques
- (c) Control issues.

### **3.6.5 The database warehouse approach:**

- (a) Introduction to databases
- (b) Fundamentals/entity relationships and data flow diagrams
- (c) Access database fundamentals
- (d) Random on-line access
- (e) Shared data (use of common data structures) and system flexibility
- (f) Efficient and reliable storage
- (g) The RDBMS (Relational Data Base Management System) approach

### **3.6.6 The systems development life cycle model.**

- (a) System design methods and tools
- (b) Computer Aided Systems Engineering

### **3.6.7 Commercial software**

### **3.6.8 Change management – behavioural issues**

## **3.7 Module on business law**

The objective of this module is to survey the legal and ethical environment of business. It provide an awareness of the nation's overall legal framework within which a professional accountant operates. This includes civil law, labor law, criminal law (as it relates to business activities), tort law, contracts, warranty law, product liability, government regulation, property, as well as ethics and social responsibility. On completion of this module individuals should be able to:

- identify the main sources of law in the nation
- explain how laws are administered and how legal rules emerge in the legal system

- describe the various statutes which affect the professional accountant's work
- explain the general principles of the nation's law on contracts
- identify the major features of contracts for the sale of goods
- discuss the major legislative and common or civil law principles which govern employment relationships
- appreciate the formation of a company and distinguish between various types of companies
- describe the financing of a company, including both share and loan capital
- explain the management and administration of a company with respect to directors, company officers, auditors and company meetings.
- identify the important external regulatory bodies in the country which directly relate to company operations

### **3.7.1 General legal concepts of enforceable rights and obligations**

#### **3.7.2 Types of laws**

- (a) Constitutional laws
- (b) Administrative laws and regulations
- (c) Criminal laws
- (d) Civil laws
- (e) Fiscal laws
- (f) Mercantile (commercial laws) including laws of credit
- (g) Insolvency and bankruptcy laws

#### **3.7.3 The national legal system**

- (a) The system of courts and the administration of justice
- (b) Case laws and/or legislation and regulations affecting enterprises
- (c) Precedents and statutory interpretations
- (d) Disputes and the use of experts

#### **3.7.4 The nature, purpose, scope and key principles of national legislation, directives and case law**

#### **3.7.5 General principles of the law of contracts**

- (a) Formation of a contract
- (b) Contract contents and terms, including exclusion clauses
- (c) Discharge of a contract
- (d) Remedies for failure to perform contract terms

#### **3.7.6 Contracts for the sale of goods**

- (a) Implied and specified terms
- (b) Transfer of the possession of property
- (c) Performance
- (d) Remedies

**3.7.7 Employment contracts**

- (a) Contracts of service and for services
- (b) Unfair and wrongful dismissal
- (c) Redundancies
- (d) Remedies of employees

**3.7.8 The nature of a limited liability company**

- (a) The difference between a limited liability company and a partnership
- (b) The advantages and consequences of forming a limited liability company

**3.7.9 Company law**

- (a) The formation of a company and the nature of its constitution
- (b) The formalities and the role of the Government's Registrar of Companies
- (c) The registration of shares, directors and directors' share holdings
- (d) The contractual capacity of a company
- (e) Statutory books, records and returns required for a company

**3.7.10 Capital and the financing of companies**

- (a) Share capital
  - (i) The issuance and transfer of shares,
  - (ii) Purchase and redemption of shares,
  - (iii) Dividends
  - (iv) Charges against the capital of a company
- (b) Loan capital
  - (i) Borrowing powers
  - (ii) Types of debentures and their creation,
  - (iii) Company charges for loan capital,
  - (iv) Registration of loans,
  - (v) Remedies of loan creditors

**3.7.11 Other legal Issues**

- (a) Product liability
- (b) Intellectual property
- (c) Third party rights
- (d) Personal property

**3.7.12 Business ethics****3.8 Module on assurance and auditing fundamentals**

The objective of this module is to provide candidates with a basic understanding of the legal and professional framework within which an audit and assurance take place; an awareness of current developments in the auditing profession, and the nature and objectives of an audit, general auditing practice and other assurance services. On completion of this module individuals should be able to:

- demonstrate an understanding of the legal and professional environment within which the organization operates
- explain the nature, purpose and scope of an audit of financial statements.
- consider compliance with national laws and regulations in an audit
- appraise theoretical and regulatory national auditing frameworks and international auditing standards
- consider the ethical nature of an audit and the role of the professional auditor in today's business environment.
- Appreciate the concepts of corporate governance and the role of internal and external auditors.
- demonstrate knowledge of the ~~describe~~ audit procedures undertaken in the planning of an audit
- discuss the nature of internal controls, the procedures required to evaluate control risk and the use of tests of control
- show understanding of the audit process and the nature of audit evidence and explain the methods for collecting and evaluating audit evidence and present information
- demonstrate ability to apply audit techniques
- understand other basic phases in performing audits including effectively selection and presentation of information and audit reports.
- demonstrate knowledge of audit concepts within both manual and computerized environments
- explain the nature, scope, function and objectives of internal auditing.
- Demonstrate the relationship and the roles of internal auditing, internal control and external auditing.

### **3.8.1 The nature, purpose and scope of an audit**

- (a) The historical development of auditing
- (b) The ethical base of auditing
- (c) The notion of accountability, stewardship and agency
- (d) The social concept of an audit and its changing role

### **3.8.2 The regulatory framework of auditing and international standards on auditing**

- (a) Auditing standards: their nature, purpose, scope and development
- (b) National bodies that set auditing standards and guidelines – their role and responsibilities
- (c) National legislation that affects auditors – the role of government in relation to auditors and the auditors' responsibility to consider national laws and regulations in an audit of financial statements
- (d) National supervision and monitoring of auditors
- (e) The role of the International Federation of Accountants (IFAC)
- (f) International Standards on Auditing (ISAs): their nature, purpose, scope and development
- (g) The conceptual framework of ISAs
- (h) The relationship between ISAs and national standards on auditing
- (i) The role of parties in relation to auditing and corporate governance issues, including the regulatory and enforcement authority, management, internal auditors and the audit committee of the company's board of directors

**3.8.3 The fundamental principles and concepts of auditing**

- (a) Appointment of auditors
- (b) Management's role and responsibilities in an audit and the audit engagement letter
- (c) Auditor independence, objectivity and integrity
- (d) Confidentiality
- (e) Audit evidence and documentation
- (f) Due care, skill and competence
- (g) Audit risk
- (h) Materiality and judgment
- (i) Expression of an audit opinion
- (j) Audit reporting as a communication medium
- (k) Audit planning and supervision
- (l) Quality control and review

**3.8.4 The framework of auditing**

- (a) The application of fundamental auditing principles and concepts
- (b) The requirements of national companies' acts on auditing
- (c) The application of national generally accepted auditing standards
- (d) The application of ISAs and International Auditing Practice Statements
- (e) National ethical codes of conduct for professional auditors and the IFAC International Code of Ethics
- (f) The auditors' and management's responsibilities for the detection and reporting of fraud, errors and illegal acts
- (g) The ethical considerations relating to the engagement and continuance of audit clients
- (h) Communications with predecessor auditors
- (i) Withdrawal from professional engagements and factors affecting such decisions
- (j) Preparing, issuing and revising audit engagement letters
- (k) The roles of the board of directors, audit committees, and the chief financial officer (CFO)

**3.8.5 Audit evaluation and planning**

- (a) Establishment of the objectives, scope and critical aspects of an audit
- (b) The importance of knowledge of the business and other operations of the entity being audited
- (c) Development of the audit plan to meet those objectives
- (d) Performance, delegation, supervision and review of the audit work performed
- (e) Identification of sources of audit evidence and the relationship of audit evidence to critical audit objectives
- (f) Use of management estimates in performing an audit
- (g) Establishment of materiality levels, statistical sampling and sampling sizes
- (h) Determination of the areas of audit risks and the consideration of inherent risks, control risks and detection risks

- (i) Analysis of the consistency of financial and related information by substantive analysis, including analytical procedures
- (j) Design, documentation and re-evaluation of the audit plan
- (k) Evaluation of the management information systems

#### **3.8.6 Evidence collection and analysis**

- (a) Collection of evidence using a variety of sources and methods including: inspection of records, documents and tangible assets; observations of processes or procedures performed by others; oral and written inquiries to independent parties; computations, ratios, trends and other analytical procedures
- (b) Selection of audit procedures appropriate to the industry, business and core processes
- (c) Identification and application of sampling techniques
- (d) Evaluation of the evidence collected, both oral and written, for reliability and sufficiency
- (e) Recognition of mutual cooperation; similarities and differences in the work of the internal and external auditors
- (f) Recognition of the needs and limitations of the use of independent experts

#### **3.8.7 The performance of an audit**

- (a) Determination and documentation of the internal controls, including methods of preparing audit working papers
- (b) Design of the audit program
- (c) Assessment of internal controls
- (d) Performance tests of the systems controls
- (e) Evaluation of the results of tests and the re-evaluation of inherent and control risks
- (f) Application of substantive analysis, substantive sampling and evaluation of test results
- (g) Determination and analysis of the inter-relationship of tests
- (h) Alteration (modification) of tests in the light of test results
- (i) Comparison of test results with evidence from other tests, critical audit objectives, and risk evaluation and materiality levels
- (j) Response to potential weaknesses in the system and areas of concern evidenced by substantive tests
- (k) Introduction to the utilization of computer assisted audit techniques and testing management information system controls
- (l) Consideration of relevant legislation on the performance of an audit
- (m) Performance of substantive procedures in relation to balance sheet items
- (n) Evaluation of the sufficiency, relevance and reliability of evidence and amending the audit plan
- (o) Evaluation of the quality of the audit

#### **3.8.8 The audit reporting framework**

- (a) Review of events that are subsequent to the date of the balance sheet
- (b) Evaluation of going-concern risks, management representations and the truth and fairness or fair presentation (or alternative reporting requirements) of financial statements

- (c) Identification of and recommendations on compliance with enterprise policies, on appropriate actions on weaknesses and on the efficiency of operations found during the audit
- (d) Formulation of an audit opinion

### **3.8.9 Internal auditing – its objectives and functions**

## **3.9 Module on business finance and financial management**

The module views accounting students as future sophisticated technical users of financial management information with a focus on corporate and business finance. Thus, the module should be taught from an accountant's point of view i.e. emphasizing the ability to use business finance reports as well as a thorough familiarity of how these reports are prepared. Also, discussion of economic concepts and models should not overlap with what is covered in the module on economics.

The objective of this module is to provide an introduction to the theory and practice of business finance and a sound basis for further study of accounting to ensure that candidates understand the financial management methods used for analyzing the benefits of various sources of finance and capital investment opportunities. On completion of this module the individual should be able to:

- evaluate capital investments through the use of appropriate methods and techniques, and make allowances for the effects of taxes, inflation, risks, and uncertainty
- understand the financial context in which the firm operates
- analyze and evaluate different methods used in business finance decision-making
- understand the practical implications of finance theory for decision making in investment decisions
- appreciate the nature and scope of working capital management
- evaluate capital investments through the use of appropriate methods and techniques, & make allowances for the effects of taxes, inflation, risks & uncertainty
- make reasoned decisions in the area of financial management and be able to adapt to changes in factors affecting those decisions
- appreciate the interpretation, use, and limitations of financial statements and financial information

### **3.9.1 The financial objectives of different types of organizations**

- (a) The nature, purpose and scope of financial management
- (b) The relationship between financial management, management accounting and financial accounting
- (c) The relationship of financial objectives to organizational strategy and to other organizational objectives
- (d) The nature, scope and form (long-term and short-term) of financial objectives of business organizations
- (e) The roles, responsibilities and relationships of key personnel involved in and with organizations (shareholders, lenders, managers, employees, customers, suppliers and government)

### **3.9.2 The framework of financial management**

- (a) The commercial and financial environment in which organizations operate (the nature and function of the money and capital markets including banks and other financial intermediaries, and various national stock exchanges and the over-the-counter markets)
- (b) The application of macroeconomic theory as a basis for understanding the key economic variables affecting the business environment
- (c) The significance of corporate securities (share, capital, debt and preference shares) to commercial organizations and the markets in which they operate, and the influence of markets on organizations

### **3.9.3 The management of working capital**

- (a) The nature and scope of working capital management
- (b) The importance of effective working capital management to corporate survival
- (c) Credit management and cash management systems: The selection of appropriate cash balances and managing cash surplus and deficits; the nature and functions of the short-term money market
- (d) The management of debtors (including those overseas): credit evaluation; terms of credit; cash discounts; debt collection techniques; credit management monitoring and evaluation; factoring; and invoice discounting
- (e) Creditors: the advantages and disadvantages of alternative methods of paying suppliers (including those overseas); the dangers of trading on credit

### **3.9.4 The sources of finance- basic coverage (financing decisions)**

- (a) The nature and importance of internally generated funds
- (b) The cost of capital, including the calculation of effective interest rates
- (c) Capital markets, including the types of share capital, new issues, rights issues, loan capital, convertible securities and warrants
- (d) Determining the requirements for financing (how much, for how long, and for what purpose) in relation to an enterprise's operational and strategic objectives; the importance of the choice of capital structure to an organization
- (e) Identifying and evaluating appropriate sources of finance taking into account such factors as:
  - (i) Cost of finance including its servicing,
  - (ii) Timing of cash payments,
  - (iii) Effect of gearing and other ratios,
  - (iv) The effect on the company's existing investors
- (f) Other culturally-determined sources of finance

### **3.9.5 Capital expenditures and investments – basic coverage (investing decisions)**

- (a) How to identify potential investment opportunities
- (b) Financial tools:
  - (i) Compounding and Discounting: the connections with time, with purchasing power, with uncertainty,
  - (ii) Present Values, PV tables, and Net Present Value: concepts and practice.

- (c) Appraising capital investments for commercial organizations through the use of appropriate methods and techniques, including:
- (i) Return on capital employed,
  - (ii) Payback,
  - (iii) Discounting based methods, including the importance of the cost of capital to investment appraisal and shareholder value,
  - (iv) Internal rates of return.
  - (v) Net present values,
  - (vi) Capital rationing,
  - (vii) Lease or buy decisions
  - (viii) Other culturally-determined methods and techniques
- (d) Managing investment portfolios

### **3.9.6 The Dividend Decision**

### **3.9.7 Long-term financial planning**

- (a) The relationship of investment decisions to long-term financial planning
- (b) Portfolio theory and its relevance to decision-making and financial management practice Long-term financial planning
- (c) The capital asset pricing model and its uses in financial management
- (d) The significance of the dividend-based model and the capital asset pricing model in calculating the cost of capital
- (e) The cost of various forms of debt
- (f) The use of the “weighted average cost of capital” approach
- (g) The “adjusted present value” approach and its application in decision-making
- (h) Taxation and dividends; the impact of dividends on share prices
- (i) Other culturally-determined long-term financial planning issues

### **3.10 Module on knowledge integration – a capstone**

The objective of the capstone module is to provide the learning processes that develop and reinforce the integration of intellectual reasoning ability, oral and written communications, and interpersonal skills into the teaching of technical and professional subject matters. It fosters student understanding of the role of accounting in organizations and societies through carefully monitored integration of the knowledge, concepts, skills, and practical applications acquired throughout the student’s course of study. The module, taken in the last academic year of study, help students draw upon and integrates concepts from the accounting modules as well as from other business and non-business modules analysing and resolving complex accounting situations. On completion of this module, the individual should be able to:

- Understand the impact of other disciplines on the study and practice of accounting.
- Understand the multi-faceted and interrelated nature of accounting fields.
- Develop a critical understanding of how the application of accounting techniques is affected by organizational context, market developments, and a host of other social, technological, legal, ethical, environmental, regulatory, and political issues.

- Understand how accounting fits within the structure of the organization and how it relates to the external environment with particular emphasis on corporate governance issues.
- Reinforce developed skills and acquired knowledge by performing, interpreting and understanding a variety of accounting techniques useful in solving complex problems.
- Recognize the nature of organizational problem solving perspectives and complexities.
- Analyse problem situations, develop appropriate evaluatory frameworks for use in problem formulation and solution design, and show how financial analysis can enhance management strategy.
- Present findings and ideas using oral and written communication skills.
- Develop social skills by working together in a team environment.

**3.10.1 Cover emerging accounting concerns, current professional topics, environmental issues, corporate governance matters, contemporary business and societal themes, and international business developments.**

**3.10.2 Simulate real-world decision-making contexts by using local and global cases, situation analysis, guest speakers, role-play, team work, and computerized simulation games.**

- (a) Students prepare group position papers and present them in class on timely and/or controversial issues such as reporting on enterprise 's contributions to environmental problems.
- (b) Students consider cases with inherent ethical challenges and clarify, refine, and gain insights as to their values.
- (c) Request student groups to adopt a given side on an issue. Students prepare positions and debate them in class and then prepare written reaction papers.
- (d) Using exercises, students forecast uncertain environmental, social, and ethical events and interpret feedback on their impact and accuracy.
- (e) In financing, investing and/or operating decisions, incorporate the financial impact of environmental issues such as waste disposal and depletion of natural resources and the impact on cost and profit calculations in the short and long terms.
- (f) Request students to conduct applied research on tax avoidance and tax evasion issues. Ask them to prepare, discuss, and present position papers to the assigned cases in class.
- (g) Construct role-play situations that focus on regulatory matters such as legislative hearing on utility rates. Working in groups, students participate in a mock hearing to illustrate the role of accounting in regulations. Groups represent different constituencies and argue the rate case before a student group role-playing a citizen group, a utility commission or a legislative committee.
- (h) Discuss corporate governance problems and financial reporting problems issues taken from local, national, and international case studies

## **4. Elective (advanced) accounting, finance and related knowledge**

### **4.1 Module on advanced financial accounting and reporting for specialized industries**

This module deals with accounting and reporting for specialized industries and the accounting treatment and financial reporting of special situations particular to the environment. The objective of this module is to ensure that candidates who seek an in-depth coverage of financial accounting can acquire techniques and develop judgment in advanced accounting and financial reporting in specialized industries, in situations particular to the environment and in advanced accounting topics encountered by professional accountant. The module helps individuals to evaluate and react to current developments or new accounting practices. On completion of this module the individual should be able to:

- carry out and appraise financial reorganization schemes for given situations
- explain the principal aspects of company dissolutions and winding-ups
- account for business combinations (acquisitions, disposals and uniting of interests)
- prepare financial statements for partnerships, branches, joint ventures and individual companies
- prepare special reports for other organizational entities

#### **4.1.1 Financial Reporting for specialized topics**

- (a) Joint ventures and associated enterprises
- (b) Environmental cost and liabilities
- (c) Governmental assistance

#### **4.1.2 Financial reporting for specialized industries**

- (a) Incorporated enterprises, including the preparation of financial and other statements for internal and external purposes
- (b) Enterprises in the extractive industries
- (c) Construction industry and accounting for construction-type contracts
- (d) Banks, insurance companies and other financial institutions
- (e) Agricultural farms

#### **4.1.3 Accounting for foreign subsidiaries and branches, and accounting for foreign currencies**

- (a) Accounting for enterprises in the extractive industries
- (b) Accounting in the construction industry and accounting for construction-type contracts
- (c) Accounting for banks, insurance companies and other financial institutions
- (d) Accounting for agricultural farms

#### **4.1.4 Special issues relating to accounting for reconstructions, uniting of interests and business combinations**

- (a) Accounting for changes in organizational structures:

- (i) Single companies: The principles of acquisitions, financial reorganizations and rationalizations
- (ii) Groups: acquisitions and other changes of parent company interests
- (b) The major features of reorganizations, uniting of interests and takeovers, their principal aspects, regulatory and audit consequences in relation to:
  - (i) Control of business combinations and the public interests,
  - (ii) The regulation of takeovers,
  - (iii) Management responsibilities in takeover situations,
  - (iv) Minority rights

#### **4.1.5 Accounting for the winding up of an enterprise**

#### **4.1.6 Advanced analysis and appraisal of financial and related information**

- (a) Evaluating the internal consistency and validity of the information collected and otherwise produced for accounts
- (b) Identifying matters for further interpretation of information produced (e.g. by comparing it to other information such as prior years' data, budgets and other targets, industry norms, and the state of the economy)
- (c) Analyzing and interpreting accounts and statements (e.g. by ratio analysis) for indications of aspects of business performance (such as value for money, quality, long-term solvency and stability, short-term solvency and liquidity, profitability, efficiency, growth and failure prediction) using, for example;
  - (i) Inter-temporal analysis,
  - (ii) Intra- and inter-firm comparisons,
  - (iii) Trend analyses
- (d) The use of computers for financial analysis purposes;
  - (i) Horizontal analysis,
  - (ii) Vertical analysis,
  - (iii) Ratio analysis

#### **4.1.7 Financial reporting for governmental organizations**

- (a) Understand principles of accounting for state governments as well as local political subdivisions such as municipalities, ports, and fire districts.
- (b) Principles of accounting and financial reporting for state and local government.
- (c) Accounting for general funds, special revenue funds, general fixed assets, capital projects funds, general long-term debt and debt service funds.
- (d) Accounting for fiduciary and business-type activities
- (e) Analysis of governmental financial performance

#### **4.1.8 Financial reporting for non-governmental not-for-profit organizations**

- (a) Understand principles of accounting for non-profit, non-governmental colleges and universities, health care providers and voluntary health and welfare organizations.

- (b) Accounting for health care organizations
- (c) Accounting for Co-operatives

#### **4.1.9 Assessing the impact of price-level changes on financial analyses**

### **4.2 Module on advanced management accounting**

The objective of this module is ensure that candidates are competent to prepare and analyze management accounting data, apply it to a range of planning, control and decision-making situations and adapt it to accommodate change. On completion of this module the individual should be able to:

- apply management accounting techniques in planning, control and decision-making situations
- interpret information available from the use of these techniques
- explain current practical methods used in making management decisions and the influence of the environment on such decisions
- review the objectives of management accounting and its role as part of a business information system
- explain the meaning of and the accounting implications of trends in management accounting, such as world class management
- explain the nature of information, its sources, and analyses required for the operation of a management accounting system
- identify relevant costs and appropriate techniques for decision-making and use them in various decision-making situations
- identify, discuss and implement a range of product-pricing methods applicable in particular operating situations
- discuss the characteristics of strategic management accounting decisions
- discuss the performance measures appropriate to different business situations.
- Understand the role of management accounting in dealing with the non-financial performance indicators and the non-financial objectives of enterprises such as environmental and social objectives

#### **4.2.1 Business planning**

- (a) Proposing, evaluating and implementing ways to meet short and medium-term financial objectives, such as budgeting, monitoring and controlling cash flow, pricing, raising finance and repaying debt
- (b) The purpose and benefits of setting short-term objectives consistent with long-term strategies
- (c) Seeking, clarifying and confirming information relevant to the determination of business objectives, such as information on current business position and past performance by using ratios and other analyses, and information on planned changes to systems and procedures
- (d) Developing and analyzing business plans to meet agreed objectives, including risk assessment of plans and all aspects of the business that they will influence, and analyses to include measures of value, profit optimization and utility
- (e) Long-term financial planning, including:

- (i) The issues to be considered when deciding whether to expand through internal growth or through an acquisition,
- (ii) Strategies a company might use in order to expand or maintain its current market position,
- (iii) The techniques for valuing individual shares and other securities and for valuing a business, and the application of these techniques in merger and acquisition situations,
- (iv) The arguments for and against mergers and acquisitions,
- (v) Methods of financing an acquisition,
- (vi) Appropriate merger and acquisition strategies and tactics,
- (vii) Tactics to follow when defending against a takeover bid,
- (viii) Planning for post-merger success and post-merger audits,
- (ix) Identifying schemes for financial restructuring and the issues involved in the decision process; methods of restructuring; buy-outs; going private; share repurchases; rescheduling debts; and joint ventures

#### **4.2.2 The design of management accounting systems**

- (a) Developing and implementing appropriate systems
  - (i) Identification of cost units,
  - (ii) Establishing cost, profit and responsibility centers,
  - (iii) Determining methods for recording relevant information,
  - (iv) The sources of information for recording and processing,
  - (v) Computer-based information storage and processing,
  - (vi) Analysis of output information and its dissemination to relevant individuals and departments
- (b) Consideration and application of information requirements in relation to:
  - (i) The costing and processing of products and services,
  - (ii) Preparing operating plans,
  - (iii) Monitoring and controlling performance,
  - (iv) Decision-making considerations
- (c) Considerations in negotiating and agreeing information requirements
  - (i) The influence of size and the type of enterprise entity,
  - (ii) The nature of activities and output of each entity,
  - (iii) The long-term or short-term nature of decisions,
  - (iv) Management structures and styles,
  - (v) Conditions of uncertainty and risk,
  - (vi) Qualitative and quantitative nature of the information requirements,
  - (vii) Frequency, timing, format and degree of accuracy required

#### **4.2.3 Evaluating the impact of changes in business structures, functions and performance measures on the applicability and appropriateness of management accounting techniques and methods.**

**4.2.4 Performance measurement for planning and control:**

- (a) Measurement of activity, productivity, profitability, quality and service
- (b) The relationship of measurements to the type of entity (e.g. manufacturing or service, profit or non-profit, centralized or decentralized entity)
- (c) Ranges of measures: monetary and non-monetary; the use of percentages, ratios and indices
- (d) The use of indices to allow for price and performance changes through time
- (e) Identification of areas of concern from the information produced
- (f) Relationship between business performance and managerial performance
- (g) Assessing management performance by reference to comparable internal and external information

**4.2.5 Other information for decision-making purposes**

- (a) Identification and application of relevant costs and appropriate techniques
  - (i) Relevant costs, such as fixed or variable, direct or indirect, avoidable or unavoidable, and opportunity or sunk costs,
  - (ii) Appropriate techniques, such as cost/volume/profit analysis, the use of limiting factors, and the recognition of risks and uncertainties
- (b) Use of relevant information for:
  - (i) Application and interpretation of quantitative techniques for decision-making purposes,
  - (ii) Adoption of new products,
  - (iii) Product mix choices,
  - (iv) Discontinuance of products,
  - (v) Make or buy decisions,
  - (vi) Decisions to sell or to further process products,
  - (vii) Decisions to shutdown or temporarily close selected operations,
  - (viii) The use of indexing of costs and revenues data, (ix) the use of discounted cash flow techniques in longer-term decision-making situations

**4.2.6 Non-financial performance indicators such as productivity per employee or per service unit.****4.2.7 The non-financial objectives of enterprises such as environmental and social objectives.****4.3 Module on advanced taxation**

The objective of this portion is to develop students' investigative skills through a study of specialized taxation topics relevant to the local needs, develop students' analytical skills through the application of complex taxation policy to practical problems, deepen knowledge of the theoretical and practical aspects of the tax system and extend general theoretical awareness of a the full range of the major taxes within the nation. On completion of this module the individual should be able to:

- Perform Tax planning
- Understand tax avoidance vs. tax evasion
- Understand and perform Inheritance Tax planning and calculation
- Develop working knowledge to deal with VAT, issues & accounting for VAT
- Understand Non-domestic (foreign) activities giving rise to taxation liabilities
- Special regulations applicable to groups of companies
- Understand Trusts and how they function
- Deal with taxes such as excise taxes and road taxes
- Deal with specialized tax issues and policies relevant to the local needs

#### **4.3.1 The income taxation of employees and unincorporated businesses**

- (a) The general basis for assessing taxes
- (b) Calculating tax liabilities
- (c) Minimizing and deferring tax liabilities by identifying relevant exemptions, relief and allowances

#### **4.3.2 Trusts**

#### **4.3.3 Non-domestic (foreign) activities giving rise to taxation liabilities**

- (a) Definitions of residence and domicile
- (b) The national taxation of income earned in the country and gains of non-domiciled individuals
- (c) The taxation of national residents
- (d) The national taxation of overseas gains and income attributable to corporations and to individuals
- (e) The effect of national tax treaties with other countries on tax liabilities
- (f) The effect of business structures (branches, subsidiaries) on tax liabilities
- (g) The effect of transfer pricing on overseas and national tax liabilities
- (h) Other tax planning considerations

#### **4.3.4 Taxation treatment and special concessions of emigrant workers remittances**

#### **4.3.5 Value-added tax schemes- C/E**

#### **4.3.6 Inheritance tax –C/E**

#### **4.3.7 Other taxes (excise taxes and road taxes) and culturally-determined taxes – C/E**

#### **4.3.8 National insurance schemes –C/E**

#### **4.3.9 Social security schemes –C/E**

#### **4.4 Module on advanced business law**

The objective of this module is to cover topics of special legal issues specific to the local needs such as national security laws, to allow for an in depth coverage of topics in the

core module, and to expand coverage of ethical, social, legal, and regulatory environment of business. On completion of this module individuals should be able to:

- explain the management and administration of a company with respect to directors, company officers, auditors and company meetings
- understand the intricacies of management and administration of companies
- understand the nature of a limited liability company
- acquire knowledge as to the laws of associations such as clubs and partnerships
- discuss and the legal, social, regulatory, and ethical environments of business
- understand other legal issues peculiar to the local setting.

#### **4.4.1 The nature of a limited liability company**

- (a) The difference between a limited liability company and a partnership
- (b) The advantages and consequences of forming a limited liability company

#### **4.4.2 Capital and the financing of companies**

- (a) Share capital
  - (i) The issuance and transfer of shares,
  - (ii) Purchase and redemption of shares,
  - (iii) Dividends
  - (iv) Charges against the capital of a company
- (b) Loan capital
  - (i) Borrowing powers
  - (ii) Types of debentures and their creation,
  - (iii) Company charges for loan capital,
  - (iv) Registration of loans,
  - (v) Remedies of loan creditors

#### **4.4.3 The management and administration of companies**

- (a) Company directors:
  - (i) Appointment and termination of office
  - (ii) Duties and powers
  - (iii) Contractual capacity of directors
  - (iv) Self-dealing by directors
  - (v) Shareholder remedies
- (b) Company officers: titles and responsibilities
- (c) Differences between officers' and directors' duties and responsibilities
- (d) The company secretary: appointment, role and duties
- (e) Shareholders: majority control and the rights of minorities
- (f) External auditors:

- (i) The appointment and re-appointment of auditors,
- (ii) Removal, resignation and replacement of auditors
- (iii) Duties and responsibilities
  
- (g) Formal company meetings
- (h) National regulatory bodies of companies:
  - (i) Agencies applicable to all companies
  - (ii) Agencies applicable to publicly held companies, including securities and exchanges organizations
- (i) Employment laws and labor union contracts

**4.4.4 Laws of insolvency; procedures for filing for insolvency under relevant laws; rights of creditors and other interested parties.**

**4.4.5 Laws of associations such as clubs and partnerships to carry out certain activities; rights and duties of members and partners of such associations; rights of third parties; rules governing financial statements and prospectuses.**

**4.5 Module on advanced auditing**

The objective of this module is to ensure that candidates have developed a thorough knowledge and understanding of auditing principles and concepts and can begin to apply this grounding to the situations that they will typically encounter in practical work situations. On completion of this module individuals should be able to:

- interpret, apply and appraise critically emerging professional auditing issues and international standards of auditing.
- review events subsequent to the date of the balance sheet for their effect on the financial statements; review the condition of the enterprise as a going concern; review management representations; and review the truth or fairness of the information which the financial statements purport to represent
- explain the significance of communication to management and directors
- prepare and understand various forms of audit reports and their significance
- perform auditing procedures on computerized business systems
- be familiar and understand audit software uses and limitations
- discuss and implement advanced and specialized auditing practices and procedures
- understand auditors' professional liabilities
- understand operations auditing and how it relates to financial auditing
- understand basic features of environmental auditing, how to perform and how it is related to financial auditing.

**4.5.1 Communications with boards of directors and management concerning internal control weaknesses detected in audits**

**4.5.2 Evaluation of computer-based systems (align with AIS and IT modules)**

- (a) Legal, ethical, auditing and information system control standards:

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- (i) Legal and ethical requirements,
  - (ii) Auditing standards relevant to information technology (IT),
  - (iii) Computer control guidelines
- (b) Evaluation objectives:
- (i) Efficiency, effectiveness and economy of IT use,
  - (ii) Compliance with policies, statutes and regulations,
  - (iii) Evaluation of internal control in computer-based systems,
  - (iv) Fairness of financial statement representations and the accuracy and completeness of accounting records
- (c) Evaluation methods and techniques:
- (i) Planning, scheduling and staffing
  - (ii) Obtaining an understanding of systems in the business context
  - (iii) Documenting systems and elements of control structure,
  - (iv) Tests of features, controls, transactions and balances,
  - (v) Supervision, review and quality assurance
- (d) Communicating the results of evaluations:
- (i) Types of reports,
  - (ii) Levels of assurance,
  - (iii) Importance of communication skills
- (e) Following up– frequency, timing & reporting
- (f) Specific types of evaluations:
- (i) System acquisition and development,
  - (ii) System implementation,
  - (iii) System maintenance and program changes,
  - (iv) IT asset safeguarding,
  - (v) Data integrity, privacy and security,
  - (vi) Continuity of processing and disaster recovery, planning,
  - (vii) System processing operations and related activities,
  - (viii) Application processing.
- (g) Computer-assisted audit techniques (CAATs):
- (i) Approaches,
  - (ii) Professional standards,
  - (iii) Feasibility considerations,
  - (iv) Categories, definition and design of CAATs,
  - (v) Execution and control of CAATs

#### **4.5.3 Audit software (align with AIS module and IT module)**

- (a) Capabilities and limitations of generalized audit software
- (b) Steps in managing generalized audit software
- (c) Problems in using generalized audit software
- (d) Capabilities and limitations of industry-specific audit software
- (e) Use of systems software and specialized audit software

- (f) Control and integrity issues in specialized audit software

#### **4.5.4 Auditors' risks of professional liabilities**

- (a) Significance of the problem
- (b) Functions and duties of independent auditors for serving the public interest – clients and third parties
- (c) Auditors' liabilities to clients and to third parties for their actions
- (d) Liability laws in civil law countries
- (e) Liability laws in common law countries
- (f) Fraud vs. negligence
- (g) Professional liability insurance
- (h) What auditors can and should do to minimize their risks
- (i) Corporate governance and the auditors

#### **4.5.5 Organizing and planning complex audit situations, including group audits and joint audits applying international auditing standards**

- (a) Using the work of internal auditors, other external auditors and independent experts
- (b) Special purpose audit engagements, including investigations, and related service engagements
- (c) Attestation services
- (d) Auditing for compliance with laws and regulations
- (e) Other auditing of performance
- (f) Reviewing financial statements for compliance with International Accounting Standards
- (g) Monitoring and evaluating important theories, developments, issues and controversies in international accounting and auditing standards, international case law and audit regulations and their implications for the auditing profession
- (h) Monitoring the impact of information systems development on the audit process, including the impact of computers on the auditing process
- (i) Audits of banks, insurance companies and other financial institutions
- (j) Audits of small businesses
- (k) Auditing of governmental organizations
- (l) Auditing of other not-for-profit organizations
- (m) Non-financial auditing – types, objectives and methods; management auditing and operational auditing by professional accountants

#### **4.5.6 Environmental audit**

- (a) Environmental performance indicators
- (b) Financial performance indicators
- (c) Accounting issues in environmental audit
- (d) Audit report

#### **4.5.7 Operations and performance auditing**

## 4.6 Module on advanced business finance and financial management

The objective of this module is to establish and deepen critical analysis of the financial management function, to provide an advanced analysis of the theory and practice of business finance to ensure that candidates understand advanced financial management tools and techniques and be able to deal with special problems of financial management in the public sector as well as concepts, tools, and techniques of treasury management. On completion of this module the individual should be able to:

- identify appropriate sources of finance for particular situations and assess the impact of each upon the capital structure of a particular entity
- understand the concepts behind available theoretical financial models and assess the relevance of developments in financial management theory to an enterprise
- select the techniques most appropriate to optimize the employment of resources including the most effective method of financing
- understand the workings of the national and international financial systems and evaluate alternative sources of finance
- describe and discuss the development of the function of treasury management within organizations, in particular the working capital aspects and international considerations
- appreciate the interpretation, use, and limitations of financial statements and financial information
- demonstrate the theory behind risk analysis and how to quantify risk
- demonstrate awareness of the issues surrounding the optimum cash balance and the cost of capital as the link between the firms financing and investment decisions
- critically analyze and evaluate available methods of asset pricing
- appraise, select and apply models for the analysis of investments within a portfolio context
- appraise and measure the performance and management of investment portfolios
- discuss and apply derivatives analysis to the control of contemporary business, commercial and other organizations
- comprehend the regulation of financial markets from the standpoint of the impact of derivatives.

### 4.6.1 The financial objectives of special types of organizations

- (a) The nature, purpose and scope of financial management
- (b) The nature, scope and form (long-term and short-term) of financial objectives of special types of organizations, including not-for-profit organizations
- (c) Problems faced by small enterprises in obtaining financing

### 4.6.2 The framework of financial management

- (a) Advanced applications of macroeconomic theory as a basis for understanding the key economic variables affecting the business environment
- (b) Fiscal policies: their nature and the effectiveness of fiscal policy
- (c) Money and interest rates, the role of money in the economy, and the supply and demand for money –
- (d) Monetary policies: attitudes to monetary policies and their problems

- (e) Supply-side policies and problems and policies to improve supply-side policies
- (f) Policies towards monopolies and oligopolies, privatization and deregulation
- (g) Environmental (“green”) policies and their implications for the management of the economy and the firm
- (h) The “efficient markets” hypothesis and its relevance to decision-making and to financial management practice

#### **4.6.3 Special problems of financial management in the public sector.**

#### **4.6.4 The sources of finance- in-depth coverage (advanced financing decisions and culturally-determined issues.**

- (a) The impact of capital market derivatives
- (b) The determination of equity prices –
- (c) The effect of dividend policies on financial needs and the formulation of dividend policies
- (d) Bank finance: the various forms of short-, medium- and long-term finance that are available, including leasing arrangements
- (e) Trade credit
- (f) Government sources: grants, local, regional and national aid schemes, tax incentives, etc.
- (g) Venture capital and financial sources particularly suited to the small enterprise
- (h) International money and capital markets, including banking and the financing of foreign trade
- (i) Determining the requirements for financing (how much, for how long, and for what purpose) in relation to an enterprise’s operational and strategic objectives; the importance of the choice of capital structure to an organization
- (j) Financial and actuarial mathematics
- (k) Calculating financial gearing and other key financial ratios and analyzing their significance to the organization
- (l) Negotiating term loans with banks and other financial institutions
- (m) Micro credit programs to finance development in rural areas

#### **4.6.5 Capital expenditures and investments – in-depth coverage (advanced investing decisions as well as culturally-determined issues)**

- (a) How to identify potential investment opportunities
- (b) Appraising capital investments for non-commercial organizations through the use of appropriate methods and techniques, including:
  - (i) Return on capital employed
  - (ii) Payback
  - (iii) Discounting based methods, including the importance of the cost of capital to investment appraisal and shareholder value
  - (iv) Internal rates of return.
  - (v) Net present values
  - (vi) Capital rationing,
  - (vii) Lease or buy decisions

- (c) The effects of taxation and inflation on investment decisions and the handling of risks and uncertainties, for example through the use of probabilities, sensitivity analysis and simulations
- (d) Portfolio performance

#### **4.6.6 Treasury management**

- (a) Optimizing the flow of financial assets for an organization or an individual
- (b) Risk management and cost saving within the organization by use of:
  - (i) Options, including caps, floors and collars
  - (ii) Futures
  - (iii) Swaps
- (c) The scope and benefits of financial engineering
- (d) Foreign exchange markets and hedging against foreign exchange risks
- (e) The use of financial derivatives, including the Black-Scholes option-pricing model
- (f) Derivative regulations & accounting standards

#### **4.7 Module on accounting internship**

If the curriculum is delivered by an academic institution formalized learning experience in combination with practice of accounting while engaged in an internship with a public accounting firm, business, or other off-campus organization is highly encouraged, thus the accounting internship module. Students should be encouraged to have an internship for few weeks during the last two years of their studies. These internship opportunities should be made available by professional bodies, accounting firms, industry, and government. If the internship module is offered as part of the formal student academic program, the academic institution should specify the requirement of successful completion of the internship. For example, a student taking the internship as a module prior approval of learning plan, a project, and a summary report of learning experience should be required of the student.. Students should devote a specified number of hours between internship employment hours and student-intern project hours. The primary objective of the student intern project is to enhance the educational value of the student's internship experience. The academic institution should issue guidelines as to the type of work expected of the intern during the internship and the extent of compensation, if any.